[Reserved]

INTRODUCTION

This section is designed to help the examiner develop an overview of a bank's financial condition and results of operations through the use of analytical review techniques. It also provides procedures to assist in evaluating the reasonableness and reliability of the bank's income and expense accounts. (However, no analytical view of a bank's operating results is complete without due consideration of the stability and probable continuity of the earnings. In this regard, the examiner must remain cognizant of the inextricable links between liquidity and earnings and the implications of a bank's funds management decisions, particularly those dealing with interest-rate risk.

GENERAL EXAMINATION APPROACH

The review and analysis of the bank's financial condition and results of operations should begin during the pre-examination analysis of the bank (see ''Examination Strategy, section 1000). Pre-examination analysis is meant to determine potential problem areas so that proper staff levels and appropriate examination procedures can be used. The analysis will be performed using the most recent Uniform Bank Performance Report (UBPR). (See ''Federal Reserve System Surveillance Program,'' section 1020.)

Questions raised during the preliminary review should be answered and substantiated soon after commencing the examination, while performing the more comprehensive analytical review. The analytical review should use the UBPR financial statements and reports, detail trial balances, analyses of accounts, financial budgets, statistical information, and any other relevant data available at the bank. Explanations for unusual conditions identified during the review, and work performed to substantiate such explanations, should be documented in the examination workpapers.

If internal or external auditors have not performed adequate audit procedures relating to income and expenses, the examiner should test check computations for accuracy and trace entries to appropriate accounts. (See ''Internal Control,'' section 1010, for a discussion of procedures to use in reviewing the audit work of others.)

ANALYTICAL REVIEW

Analytical review involves a comparison of detail balances or statistical data on a period-to-period basis in an effort to substantiate reasonableness without systematic examination of the transactions comprising the account balances. Analytical review is based on the assumption that comparability of period-to-period balances and ratios shows them to be free from significant error. A well-performed analytical review not only benefits the examination by providing an understanding of the bank's operations, but also highlights matters of interest and potential problem situations which, if detected early, might avert more serious problems.

Analytical Tools

The basic analytical tools available to the examiner are the UBPR and the bank's financial statements. Internally prepared statements and supplemental schedules, if available, are excellent additions to an in-depth analytical review. The information from those schedules may give the examiner considerable insight into the interpretation of the bank's basic financial statements. However, internally prepared information alone is not sufficient to adequately analyze the financial condition of the bank. To properly understand and interpret financial and statistical data, the examiner should be familiar with current economic conditions and with any secular, cyclical, or seasonal factors in the nation, region, and local area, including general industry conditions. Economic and industry information, reports, and journals are an important source for knowledge of industry conditions. Finally, the examiner should be knowledgeable about new banking laws and pending legislation that could have a material impact on financial institutions.

Review of Financial Statements

An analytical review of a bank's financial statements requires professional judgment and an inquiring attitude. During the analysis, the examiner should avoid details not specifically related to his or her objective so that excessive time is not spent analyzing relatively immaterial amounts.

Generally, it is more efficient to review financial data that has been rounded to the nearest thousand. Undue precision in computing and reviewing ratios should be avoided. An evaluation of the meaning of the ratios and amounts being compared is important; little can be gained by computing ratios for totally unrelated items. When comparing bank data to peer-group data, the examiner should consider whether the bank is typical of its peer group (a group of banks of similar size and reporting characteristics). For example, the bank might be of comparable size to its peers, but still be atypical because its earning assets are comprised principally of agricultural loans or mortgage loans. The age of the institution should also be taken into account when using peer-group data, as newly chartered de novo banks tend to produce distorted ratios (versus the peer group).

Alternative accounting treatments for similar transactions among peer banks also should be considered because they may produce significantly different results. The analytical review must be based on figures derived under valid accounting practices consistently applied, particularly in the accrual areas. Accordingly, during the analytical review, the examiner should determine any material inconsistencies in the application of accounting principles.

The examiner also should be aware of the difficulty of interpreting the cash basis accounting method. Any required adjustments should be documented and explained in the workpapers and examination report.

UBPR

Another analytical tool available to the examiner is the UBPR. The user's guide for the UBPR explains how a structured approach to financial analysis should be followed. This approach breaks down the income stream into its major components of interest margin performance, overhead, noninterest income, loan-loss provisions, tax factors, and extraordinary items. These major components can then be broken down into various subcomponents. Also, the balance-sheet composition, along with economic conditions, must be analyzed to explain the income stream and its possible future variability.

In addition to UBPR analysis and review of bank financial statements, the examiner should incorporate a review of management's budget and/or projections into his or her analysis. A review of projections and individual variances from the operating budget can often provide valuable insight into an institution's prior and future earnings. The examiner should also verify the reasonableness of the budgeted amounts, frequency of budget review by bank management and the board of directors, and level of involvement of key bank personnel in the budget process.

The primary source of information used to prepare UBPRs are the Consolidated Reports of Condition and Income, which are filed quarterly. The content and frequency of these reports are sufficient to allow the reviewer of the UBPR to detect unusual or significantly changed circumstances within a bank, and they normally will be adequate for the purposes of analytical review. Accordingly, the examiner must check these consolidated reports to ensure the resulting accuracy of the UBPRs.

Frequently, the examiner may be interested in a more detailed and current review of the bank than that provided by the UBPR system. Under certain circumstances, UBPR procedures may need to be supplemented because—

- asset quality information must be linked to the income stream;
- more detailed information is necessary on asset-liability maturities and matching;
- more detailed information is necessary on other liquidity aspects, as they may affect earnings;
- yield or cost information, which may be difficult to interpret from the report, is needed;
- certain income or expense items may need clarification, as well as normal examination validation;
- volume information, such as the number of demand deposits, certificates of deposit, and other accounts, is not reported, and vulnerability in a bank subject to concentrations normally should be considered;
- components of interest and fees on loans are not reported separately by category of loan; thus, adverse trends in the loan portfolio may not be detected (For example, the yield of a particular bank's loan portfolio may be similar to those of its peer group, but the examiner

may detect an upward trend in yields for a specific category of loans. That upward trend might be partially or wholly offset by a downward trend of yields in another category of loans, and the examiner should consider further investigating the circumstances applicable to each of those loan categories. A change in yields could be a result of a change in the bank's "appetite" for certain types of loans or may indicate a change in loan underwriting standards.); or
- income or expense resulting from a change in the bank's operations, such as the opening of a new branch or starting of a mortgage banking activity or trust department, may skew performance ratios. (When there has been a significant change in a bank's operations, the examiner should analyze the potential impact of the change on future bank earnings.)

Written Analysis

After the examiner has completed the analytical review of income and expense, he or she should prepare a written analysis to be submitted to the examiner-in-charge. This evaluation should include, but is not limited to, a review of the bank's—

- quality and future prospects for core income;
- ability to cover losses and maintain adequate capital, including compliance with the minimum capital standard;
- earnings levels and trends;
- composition of earnings and sustainability of the various earnings components (This may include a discussion of balance-sheet composition, particularly the volume and type of earning assets and off-balance-sheet items, if applicable.);
- peer-group comparisons;
- vulnerability to interest-rate and other market or price risks;
- income and expense accounts, and their reliability, including applicable accounting practices, internal controls, and audit methods;
- compliance with laws and regulations relating to earnings and dividends; and
- budgeting process and the levels of management involved in it.

Examiners should consider the adequacy of provisions to the loan-loss reserve. If the examiners conducting the asset quality review determine that the loan-loss reserve is inadequate, the bank's earnings are inflated and should be restated accordingly. In turn, this determination should be factored into the examiner's assessment of management, including its responsibility to maintain an adequate loan-loss reserve.

Consideration should also be given to the interrelationships that exist between the dividend-payout ratio, the rate of growth of retained earnings, and the adequacy of bank capital. Examiners should consider the extent to which extraordinary items, securities transactions, and taxes affect net income. The links between earnings and liquidity and the implications of a bank's funds management decisions, particularly with respect to interest-rate sensitivity, should also be fully analyzed.

1. To detect significantly changed circumstances before or as early as possible during the examination so that any impact on the determination of the scope and conduct of the examination may be assessed.
2. To analyze the financial position and operations of the bank and to investigate any unusual fluctuations.
3. To assist in determining the reliability of the bank's financial information and the consistency of the application of accounting principles.
4. To determine if accounting policies, practices, procedures, and internal controls relating to income and expenses are adequate.
5. To determine the scope and adequacy of the audit function.
6. To determine compliance with laws and regulations relating to income and expenses to the extent that such compliance is not covered elsewhere in the examination.
7. To initiate corrective action when deficiencies or violations of law or regulation have been discovered.

1. Obtain the Uniform Bank Performance Report and, through a general review of it, note any conditions of interest particularly significant changes in trends and levels of income and expense categories that would indicate present problems or shifts in business emphasis including new directions or activities undertaken.
2. Determine early in the examination if any significant changes have occurred in:
   - Operations.
   - Accounting practices or records.
   - Financial reporting.
   - General business conditions.
3. If selected for implementation complete or update the Income and Expense section of the Internal Control Questionnaire.
4. Based on the evaluation of internal controls, the work performed by internal/external auditors and the results of performing the above procedures, determine the scope of the examination.
5. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures.
6. Obtain the bank's current financial statements, internal operating reports, interim financial statements, reports filed with the Federal Reserve and daily statements of condition or other available financial information, then review balances and amounts relative to information in the UBPR staying alert for the development or continuation of adverse trends and other significant or unusual trends or fluctuations. Primary considerations should include whether:
   - Significant structural changes are occurring in the bank that may impact the earnings stream.
   - The bank is making use of tax carrybacks or carryforwards.
   - Earnings are static or declining as a percentage of total resources.
   - Income before securities gains and losses is decreasing as a percentage of total revenues.
   - The ratio of operating expense to operating revenue is increasing.
   - Earnings trends are inconsistent.
   - The spread between interest earned and interest paid is decreasing.
   - Loan losses are increasing.
   - Provisions for loan losses are sufficient to cover loan losses and maintain reserves at an adequate level.
   - There is evidence that sources of interest and other revenues have changed since the last examination.
   - Earnings are deemed inadequate to provide increased capitalization commensurate with the bank's growth.
7. Obtain and review the bank's formalized planning procedures, profit plans, budgets, mid- and long-range financial plans, economic advisory reports, and any progress reports related to any of those and:
   a. Compare actual results to budgeted amounts.
   b. Determine the impact of any broad and important specific goals which have been set.
   c. Determine the frequency of planning revisions.
   d. Determine what triggers a specific plan revision.
   e. Determine who initiates plan revisions.
   f. Determine whether explanations are required for significant variations and whether causes are ascertained in implementating corrective action.
   g. Determine the sources of input for forecasts, plans and budgets.
   h. Extract any information considered relevant to the completion of ''Management Assessment'' and ''Overall Conclusions Regarding Condition of the Bank.''
8. Scan ledger accounts for unusual entries, as considered necessary. Examples of such items include:
   - Significant deviations from the normal amounts of recurring entries.
   - Unusual debit entries in income accounts or unusual credit entries in expense accounts.
   - Significant entries from an unusual source, such as a journal entry.
   - Significant entries in ''other income'' or ''other expense'' which may indicate fees or service losses on an off balance sheet activity (i.e., financial advisory or underwriting services).

9. Investigate, as appropriate, conditions of interest disclosed by the procedures in steps 1 and 2 and 6 through 8 by:
   a. Discussing exceptions or questionable findings with the examiner responsible for conducting those aspects of the examination which are most closely related to the item of interest, to determine if a satisfactory explanation already has been obtained.
   b. Reviewing copies of work papers prepared by internal auditors or management that explain account fluctuations from prior periods or from budgeted amounts.
   c. Discussing unresolved items with management.
   d. Reviewing underlying supporting data and records, as necessary, to substantiate explanations advanced by management.
   e. Performing any other procedures considered necessary to substantiate the authenticity of the explanations given.
   f. Reaching a conclusion as to the reasonableness of any explanations offered by other examiners or management and deciding whether extensions of examination or verification procedures are necessary.
10. Determine compliance with appropriate laws and regulations.
11. Review with officers of the bank and prepare, in appropriate report format, listings of:
    a. Deficiencies in and deviations from, policies, practices, procedures, and internal controls.
    b. Violations of law.
    c. Adverse trends.
    d. Any UBPR peer group or local constructed peer group data which should be brought to the attention of management.
    e. Comments on earnings.
12. Update workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures over income and expenses. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

GENERAL

1. Does the bank have a budget? If so:
   a. Is it reviewed and approved by managerial personnel and/or the board of directors?
   b. Is it periodically reviewed and updated for changed conditions?
   c. Are periodic statements compared to budget and are explanations of variances reviewed by managment?
   d. Is a separate budget prepared by the manager of each department or division?
2. Does the bank's accounting system provide sufficiently detailed breakdowns of accounts to enable it to analyze fluctuations?

*3. Are the general books of the bank maintained by someone who does not have access to cash?

4. Are all general ledger entries processed through the proof department?
5. Are all entries to the general ledger supported by a general ledger ticket?
6. Do general ledger tickets, both debit and credit, bear complete approvals, descriptions and an indication of the offset?

*7. Are all general ledger entries approved by a responsible person other than the general ledger bookkeeper or person associated with its preparation?

8. Is the general ledger posted daily?
9. Is a daily statement of condition prepared?

*10. Are corrections to ledgers made by posting a correcting entry and not by erasing (manual system) or deleting (computerized system) the incorrect entry?

11. Are supporting worksheets or other records maintained on accrued expenses and taxes?
12. Are those supporting records periodically reconciled with the appropriate general ledger controls?

PURCHASES

*13. If the bank has a separate purchasing department, is it independent of the accounting and receiving departments?

*14. Are purchases made only on the basis of requisitions signed by authorized individuals?

*15. Are all purchases routed through a purchasing department or personnel functioning in that capacity?

16. Are all purchases made by means of prenumbered purchase orders sent to vendors?
17. Are all invoices received checked against purchase orders and receiving reports?
18. Are all invoices tested for clerical accuracy?
19. Are invoice amounts credited to their respective accounts and tested periodically for accuracy?

DISBURSEMENTS

*20. Is the payment for all purchases, except minor items, made by official checks?

*21. Does the official signing the check review all supporting documents?

*22. Are supporting vouchers and invoices cancelled to prevent re-use?

*23. Are duties and responsibilities in the following areas segregated?
   a. Authorization to issue expense checks?
   b. Preparation of expense checks?
   c. Signing of expense checks?
   d. Sending of expense checks?
   e. Use and storage of facsimile signatures?
   f. General ledger posting?
   g. Subsidiary ledger posting?

PAYROLL

24. Is the payroll department separate from the personnel department?
25. Are signed authorizations on file for all payroll deductions including W-4s for withholding?
26. Are salaries authorized by the board of directors or its designated committee?

27. Are individual wage rates authorized in writing by an authorized officer?
28. Are vacation and sick leave payments fixed or authorized?
29. Are payrolls paid from a special bank account or directly credited to the employee's demand deposit account?
30. Are time records reviewed and signed by the employee's supervisor?
31. Are double checks made of hours, rates, deductions, extension, and footings?
32. Are payroll signers independent of the persons approving hours worked and preparation of the payroll?
33. If a check signing machine is used, are controls over its use adequate (such as a dual control)?
34. Are payrolls subject to final officer approval?
35. Are the names of persons leaving employment of the bank reported promptly, in writing, to the payroll department?
36. Are payroll expense distributions reconciled with the general payroll payment records?

CONCLUSION

37. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
38. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate, inadequate).

Funds management represents the core of sound bank planning and financial management. Although funding practices, techniques, and norms have been revised substantially in recent years, it is not a new concept. Funds management is the process of managing the spread between interest earned and interest paid while ensuring adequate liquidity. Therefore, funds management has two components—liquidity and interest rate risk management.

A sound basis for evaluating funds management requires understanding the bank, its customer mix, the nature of its assets and liabilities, and its economic and competitive environment. No single theory can be applied universally to all banks.

LIQUIDITY

Liquidity represents the ability to accommodate decreases in liabilities and to fund increases in assets. A bank has adequate liquidity when it can obtain sufficient funds, either by increasing liabilities or by converting assets, promptly and at a reasonable cost. Liquidity is essential in all banks to compensate for expected and unexpected balance sheet fluctuations and to provide funds for growth. The price of liquidity is a function of market conditions and market perception of the risks, both interest rate and credit risks, reflected in the bank's balance sheet and off-balance sheet activities. Additionally, market perception of management and strategic direction can be critical to the price of liquidity. To the extent that liquidity needs are met through holdings of high quality short-term assets, the price of liquidity is the income sacrificed by not holding longer term and/or lower quality assets. If liquidity needs are not met through liquid asset holdings, a bank may be forced to restructure or acquire additional liabilities under adverse market conditions.

Liquidity exposure can stem from both internally (institution-specific) and externally generated factors. Sound liquidity risk management should address both types of exposure. External liquidity risks can be geographic (such as premiums required on deposits at many Texas banks in the late 1980s), systemic (such as the adverse effects upon several large banks caused by the near failure of Continental Illinois Bank in 1984) or instrument-specific (such as the collapse of the Perpetual Floating Rate Note market in 1986). Internal liquidity risk relates largely to the perception of an institution in its various markets: local, regional, national or international.

Determination of the adequacy of a bank's liquidity position depends upon an analysis of its:

- Historical funding requirements.
- Current liquidity position.
- Anticipated future funding needs.
- Sources of funds.
- Options for reducing funding needs or attracting additional funds.
- Present and anticipated asset quality.
- Present and future earnings capacity.
- Present and planned capital position.

To provide funds to satisfy funding needs, a bank must perform one or a combination of the following:

- Dispose of liquid assets.
- Increase short-term borrowings (and/or issue additional short-term deposit liabilities).
- Decrease holdings of less liquid assets.
- Increase liabilities of a term nature.
- Increase capital funds.

As all banks are affected by changes in the economic climate, the monitoring of economic and money market trends is key to liquidity planning. Sound financial management can minimize the negative effects of these trends while accentuating the positive ones.

Information that management should consider in liquidity planning includes:

- Internal costs of funds.
- Maturity and repricing mismatches in the balance sheet.
- Anticipated funding needs.
- Economic and market forecasts.

Management must have an effective contingency plan that identifies minimum and maximum liquidity needs and weighs alternative courses of action designed to meet those needs. Some factors that may affect a bank's liquidity include:

- A decline in earnings.
- An increase in nonperforming assets.
- Deposit concentrations.
- A downgrading by a rating agency.
- Expanded business opportunities.
- Acquisitions.
- New tax initiatives.

Once liquidity needs have been determined, management must decide how to meet them through asset management, liability management, or a combination of both.

ASSET MANAGEMENT

Liquidity needs may be met by manipulating the bank's asset structure through the sale or planned runoff of a reserve of readily marketable assets. Because many banks (primarily the smaller ones) tend to have little influence over the size of their total liabilities, liquid assets enable a bank to provide funds to satisfy increased loan demand.

Banks which rely solely on asset management concentrate on adjusting the price and availability of credit and the level of liquid assets held in response to a change in customer asset and liability preferences. However, assets that are often assumed to be liquid are sometimes difficult to liquidate. For example, investment securities may be pledged against public deposits or repurchase agreements, or may be heavily depreciated because of interest rate changes. Trading accounts cannot be reduced materially if banks must maintain adequate inventories for their customers. Furthermore, the holding of liquid assets for liquidity purposes is less attractive because of thin profit spreads.

Management must also consider the cost of maintaining liquidity. An institution that maintains a strong liquidity position may do so at the opportunity cost of generating higher earnings.

The amount of liquid assets a bank should hold depends on the stability of its deposit structure and the potential for rapid expansion of its loan portfolio. If deposit accounts are composed primarily of small stable accounts, a relatively low allowance for liquidity is necessary. Additionally, management must consider the current and expected ratings by regulatory and rating agencies when planning liquidity needs.

A higher allowance for liquidity is required when:

- High interest rates increase the potential for deposit disintermediation.
- Recent trends show a substantial increase or reduction in large deposits or borrowings.
- A significant portion of deposits are short-term municipal special assessment-type accounts.
- A substantial portion of the loan portfolio consists of large static loans with little likelihood of reduction.
- Large unused lines of credit or commitments to lend are expected to be used in the near term.
- A strong relationship exists between individual deposit accounts and principal employers in the trade area who have financial problems.
- A concentration of credit has been extended to industries with present or anticipated financial problems.

Asset liquidity, or how "salable" the bank's assets are in terms of both time and cost, is of primary importance in asset management. To maximize profitability, management must carefully weigh the full return on liquid assets (yield plus liquidity value) against the higher return associated with less liquid assets. Income derived from higher yielding assets may be offset if a forced sale, at less than book value, is necessary because of adverse balance sheet fluctuations.

Seasonal, cyclical, or other factors may cause aggregate outstanding loans and deposits to move in opposite directions and result in loan demand which exceeds available deposit funds. A bank relying strictly on asset management would restrict loan growth to that which could be supported by available deposits. As an alternative, liquidity needs may be met through liability sources, such as federal funds purchased, and sale of securities under agreements to repurchase, which would allow the bank to meet the loan demand of its trade area. If short-term funding is not readily available in the marketplace, the bank may qualify for borrowings from the local Federal Reserve Bank. The decision whether or not to use liability sources should be based on a complete analysis of seasonal, cyclical, and other factors, and the costs involved. In addition to supplementing asset liquidity, liability sources of liquidity may serve as an alternative even when asset sources are available. The number of banks relying solely on manipulation of the asset structure to meet liquidity needs is declining rapidly.

LIABILITY MANAGEMENT

Liquidity needs can be met through the discretionary acquisition of funds on the basis of interest rate competition. This does not preclude the option of selling assets to meet funding needs, and conceptually, the availability of asset and liability options should result in a lower liquidity maintenance cost. The alternative costs of available discretionary liabilities can be compared to the opportunity cost of selling various assets. The major difference between liquidity in larger banks and in smaller banks is that larger banks are better able to control the level and composition of their liabilities and assets. When funds are required, larger banks have a wider variety of options from which to select the least costly method of generating funds. In addition, discretionary access to the money markets should reduce the size of the liquid asset ‘‘buffer’’ that would be needed if the bank were solely dependent upon asset management to obtain funds.

The ability to obtain additional liabilities represents liquidity potential. The marginal cost of liquidity, the cost of incremental funds acquired, is of paramount importance in evaluating liability sources of liquidity. Consideration must be given to such factors as the frequency with which the banks must regularly refinance maturing purchased liabilities, as well as an evaluation of the bank’s ongoing ability to obtain funds under normal market conditions. The obvious difficulty in estimating the latter is that, until the bank goes to the market to borrow, it cannot determine with complete certainty that funds will be available and/or at a price which will maintain a positive yield spread. Changes in money market conditions may cause a rapid deterioration in a bank’s capacity to borrow at a favorable rate. In this context, liquidity represents the ability to attract funds in the market when needed, at a reasonable cost vis-à-vis asset yield.

As previously noted the access of a large bank to discretionary funding sources is a function of its position and reputation in the money markets. Although smaller institutions do not have a ‘‘name’’ in those markets, they are not precluded from liability management. The scope and volume of smaller institution’s operations is somewhat limited, however, particularly as they attempt to access the brokered or purchased CD market.

Although the acquisition of funds at a competitive cost has enabled many banks to meet expanding customer loan demand, misuse or improper implementation of liability management can have severe consequences. Further, liability management is not riskless. For example,

- Purchased funds may not always be available at a reasonable cost when needed. If the market loses confidence in a bank, the availability of purchased funds may be threatened.
- Concentrations in funding sources increase liquidity risk. For example, a bank relying heavily on foreign interbank deposits will experience funding problems if overseas markets perceive instability in U.S. banks or the economy. Replacing foreign source funds might be difficult and costly because the domestic market may view the bank’s sudden need for funds negatively.
- Over-reliance on liability management may cause a tendency to minimize holdings of short-term securities, relax asset liquidity standards, and result in a large concentration of short-term liabilities supporting assets of longer maturity. During times of tight money, this could cause an earnings squeeze and an illiquid condition.
- If rate competition develops in the money market, a bank may incur a high cost of funds and may elect to lower credit standards to book higher yielding loans and securities. If a bank is purchasing liabilities to support assets which are already on its books, the higher cost of purchased funds may result in a negative yield spread.
- When national monetary tightness occurs, heightened interest rate discrimination, or tiering, may develop, and may make the cost of purchased funds prohibitive to all but a small number of money center banks. Therefore, banks with limited funding sources should avoid heavy reliance on purchased funds.
- Preoccupation with obtaining funds at the lowest possible cost, without considering maturity distribution, greatly intensifies a bank’s exposure to the risk of interest rate fluctuations.

In all banks, and particularly those relying on wholesale funding sources, management must constantly be aware of the composition, characteristics, and diversification of its funding sources.

Real or perceived deterioration in the financial condition of a bank because of weak asset quality, fraud, or external economic developments will adversely affect wholesale and retail funding. The extent of market reaction depends on the composition and risk tolerance of the bank's funding base. (Risk tolerance is the willingness and ability of an individual or institution to borrow/lend money for a given risk and reward).

Many factors affect the risk tolerance of funds providers, including these:

- Obligations to fiduciary investors, such as money market funds, trust funds and pensions.
- Reliance on rating firms—bylaws or internal guidelines may prohibit placing funds in banks that have low ratings.
- Obligations to disclose information on investment holdings.
- Self-interest in maintaining an orderly marketplace—for this reason major banks are slow in eliminating funding to other banks.
- Having a personal contact at the bank to provide timely and accurate information about its financial condition.

The following common fund providers are ranked generally (while subject to change) from the least to the most risk tolerant:

- Money market funds.
- Trust funds.
- Pension funds.
- Money market brokers-dealers
  - — small denomination certificates of deposit (under $100,000) sold through broker-dealers; and
  - — large denomination certificates of deposit ($100,000 and over) sold through brokers-dealers
- Regional banks.
- Government agencies.
- Community banks.
- Insurance companies.
- Corporations.
- Multinational banks.
- Individuals.

POLICY/MANAGEMENT REPORTING SYSTEMS

Regardless of the method or combination of methods chosen to manage a bank's liquidity position, it is of key importance that the bank formulate a policy and develop a measurement system to ensure that liquidity requirements are monitored and met on an ongoing basis. This should be done in anticipation of future occurrences, both expected and unexpected. It should also reflect the bank's strategy for managing its investment portfolio and the potential for those investments to provide liquidity to the bank. Such a policy should recognize the unique characteristics of the bank and should reflect its goals. The scope of the policy will vary with the sophistication of the institution.

The policy should provide for coordination between concerned bank departments and should establish clear responsibility for decisions affecting liquidity. Senior management should be apprised regularly of liquidity conditions. Furthermore, the policy should set forth guidelines delineating appropriate levels of liquidity. Examples of some typical guidelines are listed below:

- A limit on the loan to deposit ratio.
- A limit on the loan to capital ratio.
- A general limit on the relationship between anticipated funding needs and available sources for meeting those needs (for example: the ratio of anticipated needs/primary sources shall not exceed _____ percent).
- Primary sources for meeting funding needs should be quantified.
- Flexible limits on the percentage reliance on a particular liability category (for example: negotiable certificates of deposit should not account for more than _____ percent of total liabilities).
- Limits on the dependence on individual customers or market segments for funds in liquidity position calculations.
- Flexible limits on the minimum/maximum average maturity for different categories of liabilities (for example: the average maturity of negotiable certificates of deposit shall not be less than _____ months).
- Minimum liquidity provision to be maintained to sustain operations while necessary longer-term adjustments are made.

A workable management information system is integral to making sound funds management decisions. Reports containing certain basic information should be prepared and reviewed regularly. Report content and format will vary from bank to bank depending on the characteristics of the bank and the funds management methods and practices used. Normally, a good management information system will contain reports detailing liquidity needs and the sources of funds available to meet those needs. (The maturity distribution of assets and liabilities and expected funding of commitments would prove useful in preparing this report.) Additionally, policies should establish, and the management information system should be able to track, contingency liquidity plans for use in a variety of emergency funding situations.

1. To evaluate the management of the bank's assets, liabilities, and off-balance-sheet position to determine if management is planning adequately for liquidity needs, and if the bank can effectively meet anticipated and potential liquidity needs.
2. To determine if reasonable parameters have been established for the bank's liquidity position and if the bank is operating within those established parameters.
3. To determine if internal management reports provide the necessary information for informed liquidity decisions and for monitoring the results of those decisions.
4. To urge corrective action when liquidity policies, practices, or procedures are deficient.
5. To determine if guidelines and procedures have been developed to assess the adequacy of the following: a formal contingency plan; the level of liquid assets; the ability of the bank to liquidate the loan and investment portfolios; the level of term deposits and funding lines; and whether committed funds lines are needed.

1. If internal controls or the internal audit function is determined to be inadequate, complete or update the Internal Control Questionnaire and prepare a brief description of the bank's liquidity policies and practices.
2. Review the UBPR interim financial statements and internal management reports to assess asset/liability mix and trends, paying particular attention to:
   a. deposit composition and stability;
   b. the ratios of loan commitments to total loans and standby letters of credit to total loans;
   c. the loan to deposit ratio (at community banks);
   d. the temporary investment to volatile liability ratio; and
   e. the pledged securities to total securities ratio.

   In connection with performing steps 3 through 11, keep in mind the need to evaluate the effectiveness of internal management reporting systems in providing for adequate liquidity management.
3. Determine if management has planned properly for liquidity needs and if the bank has adequate sources of funds to meet anticipated or potential needs over the short term by:
   a. Reviewing the internal management report detailing liquidity requirements and sources of liquidity.
   b. Evaluating the bank's ability to meet anticipated or potential needs.
4. Determine if management is adequately planning for longer-term liquidity/funding needs by:
   a. Discussing with management and/or reviewing budget projections for the appropriate planning period.
   b. Determine the future direction of the bank, noting the growth projected, source of funding for growth, and any projected changes in asset or liability mix.
   c. Evaluating future plans regarding liquidity needs ascertaining whether the bank can reasonably achieve the amounts and types of funding projected and can achieve the amounts and types of asset growth projected.
   d. Determine that appropriate interest rate sensitivity concerns have been addressed in planning long term funding strategies.
5. Evaluate the effectiveness of the internal management reporting system in providing for adequate liquidity management.
6. Assess the reasonableness of the parameters established by the bank with respect to the use of volatile liabilities.
   a. Does the liquidity policy incorporate limits on both the volume and intended use of such liabilities?
   b. Does the policy establish permissible ranges for maturity mismatches between volatile liabilities and assets being supported by these liabilities?
7. Review the adequacy of the bank's contingency liquidity plan.
   a. Has management determined what potential funding losses could occur if unexpected financial or operational problems arise?
   b. Have alternative funding sources and/or assets that could be sold to cover such losses been identified?
8. Does the liquidity policy restrict borrowings from affiliated banks to reasonable levels?
9. Does liquidity policy provide appropriate control and supervision of the volume of loan commitments and other off-balance-sheet activities?
10. Discuss these issues with management, and summarize your findings in the report:
    a. The quality of the bank's planning to meet liquidity needs and the current ability of the bank to meet anticipated and potential liquidity needs.
    b. The quality of administrative control and internal management reporting systems.
    c. Where appropriate the effect of liquidity management decisions on earnings.
11. Update the workpapers with any information that will facilitate future examinations. Discuss with senior management the findings of the examination of their liquidity policies and practices.

1. Has the board of directors, consistent with its duties and responsibilities, reviewed and ratified funds management policies, practices and procedures which include:
   a. Lines of authority and responsibility for liquidity management decisions?
   b. A formal mechanism to coordinate asset and liability management decisions?
   c. A method to identify liquidity needs and the means to meet those needs?
   d. Guidelines for the level of liquid assets and other sources of funds in relationship to anticipated and potential needs?
2. Does the planning and budgeting function consider liquidity requirements?
3. Have provisions been made for the preparation of internal management reports which are an adequate basis for ongoing liquidity management decisions and for monitoring the results of the decisions?
4. Are internal management reports concerning liquidity needs and sources of funds to meet those needs prepared regularly and reviewed as appropriate by senior management and the board of directors?
5. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant additional deficiencies that impair any control? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
6. Based on a composite evaluation, as evidenced by answers to the foregoing questions, are the internal controls considered adequate?

OVERVIEW

In recent years, many banking organizations have substantially increased their securitization activities. These activities involve transforming traditionally illiquid loans, leases, and other assets into instruments that can be bought and sold in secondary capital markets. Securitization can enhance both credit availability and bank profitability, but managing the risks of these activities poses increasing challenges as the risks involved, while not new to banking, may be less obvious and more complex than the risks of traditional lending activities. Securitization can involve credit, liquidity, operational, legal, and reputational risks in concentrations and forms that may not be fully recognized by bank management or adequately incorporated into an institution's risk-management systems. In reviewing these activities, examiners should assess whether banking organizations fully understand and adequately manage the full range of risks involved in securitization activities.

Banking organizations have long been involved with asset-backed securities (ABS), both as investors in them and as major participants in the securitization process. The federal government encourages the securitization of residential mortgages. In 1970, the Government National Mortgage Association (GNMA) created the first publicly traded mortgage-backed security. Shortly thereafter, the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), both government-sponsored agencies, also developed mortgage-backed securities. The guarantees on the securities that these government or government-sponsored entities provide ensure investors of the payment of principal and interest. These guarantees have greatly facilitated the securitization of mortgage assets. Banks also securitize other types of assets, such as credit card receivables, automobile loans, boat loans, commercial real estate loans, student loans, nonperforming loans, and lease receivables.

While the objectives of securitization may vary from institution to institution, there are essentially five benefits that can be derived from securitized transactions. First, the sale of assets may reduce regulatory costs. The removal of an asset from an institution's books reduces capital requirements and reserve requirements on the deposits funding the asset. Second, securitization provides originators with an additional source of funding or liquidity. The process of securitization basically converts an illiquid asset into a security with greater marketability. Securitized issues often require a credit enhancement, which results in a higher credit rating than what would normally be obtainable by the institution itself. Consequently, these issues may provide the institution with a cheaper form of funding. Third, securitization may be used to reduce interest-rate risk by improving the institution's asset-liability mix. This is especially true if the institution has a large investment in fixed-rate, low-yield assets. Fourth, by removing assets, the institution enhances its return on equity and assets. Finally, the ability to sell these securities worldwide diversifies the institution's funding base, which reduces the bank's dependence on local economies.

While securitization activities can enhance both credit availability and bank profitability, the risks of these activities must be known and managed. Accordingly, banking institutions should ensure that their overall risk-management process explicitly incorporates the full range of risks involved in their securitization activities, and examiners should assess whether institutions fully understand and adequately manage these risks. Specifically, examiners should determine whether institutions are recognizing the risks of securitization activities by (1) adequately identifying, quantifying, and monitoring these risks; (2) clearly communicating the extent and depth of these risks in reports to senior management and the board of directors and in regulatory reports; (3) conducting ongoing stress testing to identify potential losses and liquidity needs under adverse circumstances; and (4) setting adequate minimum internal standards for allowances or liabilities for losses, capital, and contingency funding. Incorporating asset securitization activities into banking organizations' risk-management systems and internal capital-adequacy allocations is particularly important since the current regulatory capital rules may not fully capture the economic substance of the risk exposures arising from many of these activities.

An institution's failure to adequately understand the risks inherent in its securitization activities and to incorporate risks into its risk-management systems and internal capital allocations may constitute an unsafe and unsound banking practice. Accordingly, for those institutions involved in asset securitization or providing credit enhancements in connection with loan sales and securitization, examiners should assess whether the institutions' systems and processes adequately identify, measure, monitor, and control *all* of the risks involved in the securitization activities.[1]

Traditional lending activities are generally funded by deposits or other liabilities, with both the assets and related liabilities reflected on the balance sheet. Liabilities must generally increase in order to fund additional loans. In contrast, the securitization process generally does not increase on-balance-sheet liabilities in proportion to the volume of loans or other assets securitized. As discussed more fully below, when banking organizations securitize their assets and these transactions are treated as sales, both the assets and the related asset-backed securities (liabilities) are removed from the balance sheet. The cash proceeds from the securitization transactions are generally used to originate or acquire additional loans or other assets for securitization, and the process is repeated. Thus, for the same volume of loan originations, securitization results in lower assets and liabilities compared with traditional lending activities.

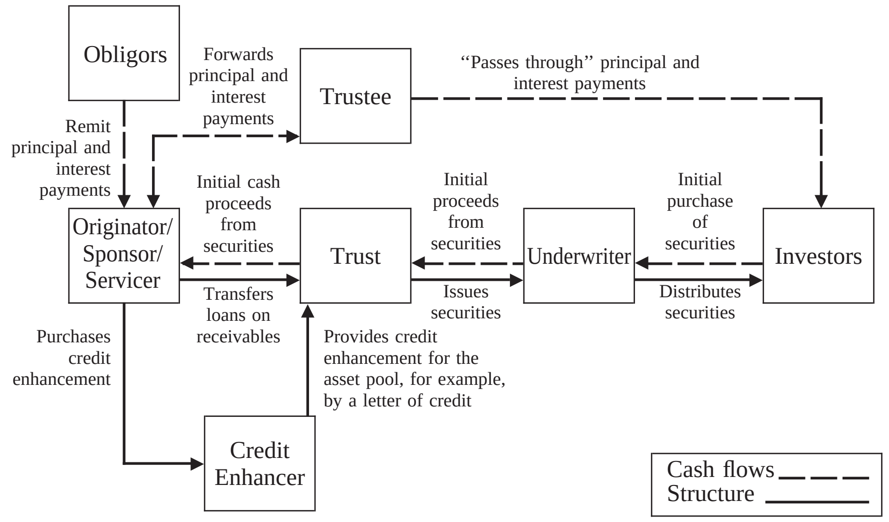
1. The Federal Reserve System has existing examiner guidance on asset securitization.

THE SECURITIZATION PROCESS

As depicted in figure 1, the asset securitization process begins with the segregation of loans or leases into pools that are relatively homogeneous with respect to credit, maturity, and interest-rate risks. These pools of assets are then transferred to a trust or other entity known as an issuer because it issues the securities or ownership interests that are acquired by investors. These ABS may take the form of debt, certificates of beneficial ownership, or other instruments. The issuer is typically protected from bankruptcy by various structural and legal arrangements. A sponsor that provides the assets to be securitized owns or otherwise establishes the issuer.

Each issue of ABS has a servicer that is responsible for collecting interest and principal payments on the loans or leases in the underlying pool of assets and for transmitting these funds to investors (or a trustee representing

Figure 1
Pass-through, asset-backed securities: structure and cash flows



them). A trustee is responsible for monitoring the activities of the servicer to ensure that it properly fulfills its role.

A guarantor may also be involved to ensure that principal and interest payments on the securities will be received by investors on a timely basis, even if the servicer does not collect these payments from the obligors of the underlying assets. Many issues of mortgage-backed securities are either guaranteed directly by GNMA, which is backed by the full faith and credit of the U.S. government, or by FNMA or FHLMC, which are government-sponsored agencies that are perceived by the credit markets to have the implicit support of the federal government. Privately issued, mortgage-backed securities and other types of ABS generally depend on some form of credit enhancement provided by the originator or third party to insulate the investor from a portion of or all credit losses. Usually, the amount of the credit enhancement is based on several multiples of the historical losses experienced on the particular asset backing the security.

The structure of an asset-backed security and the terms of the investors' interest in the collateral can vary widely depending on the type of collateral, the desires of investors, and the use of credit enhancements. Often ABS are structured to reallocate the risks entailed in the underlying collateral (particularly credit risk) into security tranches that match the desires of investors. For example, senior-subordinated security structures give holders of senior tranches greater credit-risk protection—albeit at lower yields—than holders of subordinated tranches. Under this structure, at least two classes of asset-backed securities, a senior and a junior or subordinated class, are issued in connection with the same pool of collateral. The senior class is structured so that it has a priority claim on the cash flows from the underlying pool of assets. The subordinated class must absorb credit losses on the collateral before losses can be charged to the senior portion. Because the senior class has this priority claim, cash flows from the underlying pool of assets must first satisfy the requirements of the senior class. Only after these requirements have been met will the cash flows be directed to service the subordinated class.

Credit Enhancement

ABS can use various forms of credit enhancements to transform the risk-return profile of underlying collateral. These include third-party credit enhancements, recourse provisions, overcollateralization, and various covenants and indentures. Third-party credit enhancements include standby letters of credit, collateral or pool insurance, or surety bonds from third parties. Recourse provisions are guarantees that require the originator to cover any losses up to a contractually agreed-upon amount. Some ABS, such as those backed by credit card receivables, typically use a "spread account." This account is actually an escrow account. The funds in this account are derived from a portion of the spread between the interest earned on the assets in the underlying pool and the lower interest paid on securities issued by the trust. The amounts that accumulate in the account are used to cover credit losses in the underlying asset pool up to several multiples of historical losses on the particular asset collateralizing the securities. Overcollateralization, another form of credit enhancement covering a predetermined amount of potential credit losses, occurs when the value of the underlying assets exceeds the face value of the securities.

A similar form of credit enhancement is the cash collateral account, which is established when a third party deposits cash into a pledged account. The use of cash collateral accounts, which are considered by enhancers to be loans, grew as the number of highly rated banks and other credit enhancers declined in the early 1990s. Cash collateral accounts eliminate "event risk," or the risk that the credit enhancer will have its credit rating downgraded or that it will not be able to fulfill its financial obligation to absorb losses and thus provide credit protection to investors of a securitization.

An investment banking firm or other organization generally serves as an underwriter for ABS. In addition, for asset-backed issues that are publicly offered, a credit-rating agency will analyze the policies and operations of the originator and servicer, as well as the structure, underlying pool of assets, expected cash flows, and other attributes of the securities. Before assigning a rating to the issue, the rating agency will also assess the extent of loss protection provided to investors by the credit enhancements associated with the issue.

TYPES OF ASSET-BACKED SECURITIES

Asset securitization involves different types of capital-market instruments. (For more information, see the *Trading and Capital-Markets Activities Manual*, section 4105.1, ''Asset-Backed Securities and Asset-Backed Commercial Paper,'' and section 4110.1, ''Residential Mortgage–Backed Securities.'') These instruments may be structured as ''pass-throughs'' or ''pay-throughs.'' Under a pass-through structure, the cash flows from the underlying pool of assets are passed through to investors on a pro rata basis. This type of security may be a single-class instrument, such as a GNMA pass-through, or a multiclass instrument, such as a real estate mortgage investment conduit (REMIC).[2]

The pay-through structure, with multiple classes, combines the cash flows from the underlying pool of assets and reallocates them to two or more issues of securities that have different cash-flow characteristics and maturities. An example is the collateralized mortgage obligation (CMO), which has a series of bond classes, each with its own specified coupon and stated maturity. In most cases, the assets that make up the CMO collateral pools are pass-through securities. Scheduled principal payments and any prepayments from the underlying collateral go first to the earliest maturing class of bonds. This first class of bonds must be retired before the principal cash flows are used to retire the later bond classes. The development of the pay-through structure resulted from the desire to broaden the marketability of these securities to investors who were interested in maturities other than those generally associated with pass-through securities.

Multiple-class ABS may also be issued as derivative instruments, such as ''stripped'' securities. Investors in each class of a stripped security will receive a different portion of the principal and interest cash flows from the underlying pool of assets. In their purest form, stripped securities may be issued as interest-only (IO) strips, for which the investor receives 100 percent of the interest from the underlying pool of assets, and as principal-only (PO) strips, for which the investor receives all of the principal.

In addition to these securities, other types of financial instruments may arise as a result of asset securitization, as follows:

- *Servicing assets.* These assets become a distinct asset recorded on the balance sheet when contractually separated from the underlying assets that have been sold or securitized and when the servicing of those assets is retained. (See Statement of Financial Accounting Standards No. 125 (FAS 125), ''Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,'' for more information.) In addition, servicing assets are created when organizations purchase the right to act as servicers for loan pools. The value of the servicing assets is based on the contractually specified servicing fees, net of servicing costs.
- *Interest-only strips receivables.* These cash flows are accounted for separately from servicing assets and reflect the right to future interest income from the serviced assets in excess of the contractually specified servicing fees.
- *ABS residuals.* These residuals (sometimes referred to as ''residuals'' or ''residual interests'') represent claims on any cash flows that remain after all obligations to investors and any related expenses have been met. The excess cash flows may arise as a result of overcollateralization or from reinvestment income. Residuals can be retained by sponsors or purchased by investors in the form of securities.

RISKS ASSOCIATED WITH ASSET SECURITIZATION

While clear benefits accrue to banking organizations that engage in securitization activities and invest in ABS, these activities have the potential to increase the overall risk profile of the banking organization if they are not carried out prudently. For the most part, the types of risks that financial institutions encounter in the

2. In the early 1980s, collateralized mortgage obligations (CMOs), or multiple-class securities, were introduced to help minimize the reinvestment and interest-rate risks inherent in the traditional fixed-rate mortgage-backed security. As a result of the Tax Reform Act of 1986, the REMIC was created. The REMIC is a more flexible mortgage security that expanded the appeal of the CMO structure to a wider investor base and offered preferred tax status to both investors and issuers. Today, almost all CMOs are issued in REMIC form. (''The ABCs of CMOs, REMICs and IO/POs: Rocket Science Comes to Mortgage Finance,'' *Journal of Accountancy*, April 1991, p. 41.)

securitization process are identical to those that they face in traditional lending transactions, including credit risk, concentration risk, interest-rate risk (including prepayment risk), operational risk, liquidity risk, moral-recourse risk, and funding risk. However, since the securitization process separates the traditional lending function into several limited roles, such as originator, servicer, credit enhancer, trustee, and investor, the types of risks that a bank will encounter will differ depending on the role it assumes.

Investor-Specific Risks

Investors in ABS will be exposed to varying degrees of credit risk, that is, the risk that obligors will default on principal and interest payments. As they are in direct investments in the underlying assets, investors are also subject to the risk that the various parties in the securitization structure, for example, the servicer or trustee, will be unable to fulfill their contractual obligations. Moreover, investors may be susceptible to concentrations of risks across various asset-backed security issues through overexposure to an organization performing various roles in the securitization process or as a result of geographic concentrations within the pool of assets providing the cash flows for an individual issue. Also, since the secondary markets for certain ABS are limited, investors may encounter greater than anticipated difficulties (liquidity risk) when seeking to sell their securities. Furthermore, certain derivative instruments, such as stripped asset-backed securities and residuals, may be extremely sensitive to interest rates and exhibit a high degree of price volatility. Therefore, they may dramatically affect the risk exposure of investors unless used in a properly structured hedging strategy. Examiner guidance in the *Trading and Capital-Markets Activities Manual*, section 3000.1, ‘‘Investment Securities and End-User Activities,’’ is directly applicable to ABS held as investments.

Issuer-Specific Risks

Banking organizations that issue ABS may be subject to pressures to sell only their best assets, thus reducing the quality of their own loan portfolios. On the other hand, some banking organizations may feel pressures to relax their credit standards because they can sell assets with higher risk than they would normally want to retain for their own portfolios.

Issuers may face pressures to provide ‘‘moral recourse’’ by repurchasing securities backed by loans or leases they have originated that have deteriorated and become nonperforming in order to protect their name in the market. Funding risk may also be a problem for issuers when market aberrations do not permit the issuance of asset-backed securities that are in the securitization pipeline.

Servicer-Specific Risks

Banking organizations that service securitization issues must ensure that their policies, operations, and systems will not permit breakdowns that may lead to defaults. Substantial fee income can be realized by acting as a servicer. An institution already has a fixed investment in its servicing systems and achieving economies of scale relating to that investment is in its best interest. The danger, though, lies in overloading the system’s capacity, thereby creating enormous out-of-balance positions and cost overruns. Servicing problems may precipitate a technical default, which in turn could lead to the premature redemption of the security. In addition, expected collection costs could exceed fee income. (For further guidance, examiners should see section 2040.3, ‘‘Loan Portfolio Management,’’ examination procedure 14.b.)

ACCOUNTING ISSUES

Asset securitization transactions are frequently structured to obtain certain accounting treatments, which in turn affect reported measures of profitability and capital adequacy. In transferring assets into a pool to serve as collateral for ABS, a key question is whether the transfer should be treated as a sale of the assets or as a collateralized borrowing, that is, a financing transaction secured by assets. Treating these transactions as a sale of assets results in their being removed from the banking organization’s balance sheet, thus reducing total assets relative to earnings and capital, and thereby producing higher performance and capital ratios.[3] Treating

3. See FAS 125, ‘‘Accounting for Trustees and Servicing of Financial Assets and Extinguishments of Liabilities,’’ for criteria that must be met for the securitization of assets to be accounted for as a sale.

these transactions as financings, however, means that the assets in the pool remain on the balance sheet and are subject to capital requirements and the related liabilities to reserve requirements.[4]

CAPITAL ADEQUACY

As with all risk-bearing activities, institutions should fully support the risk exposures of their securitization activities with adequate capital. Banking organizations should ensure that their capital positions are sufficiently strong to support *all* of the risks associated with these activities on a fully consolidated basis and should maintain adequate capital in all affiliated entities engaged in these activities. The Federal Reserve's risk-based capital guidelines establish *minimum* capital ratios, and those banking organizations exposed to high or above-average degrees of risk are, therefore, expected to operate significantly above the minimum capital standards.

The current regulatory capital rules may not fully incorporate the economic substance of the risk exposures involved in many securitization activities. Therefore, when evaluating capital adequacy, examiners should ensure that banking organizations that (1) sell assets with recourse, (2) assume or mitigate credit risk through the use of credit derivatives, and/or (3) provide direct credit substitutes and liquidity facilities to securitization programs are accurately identifying and measuring these exposures and maintaining capital at aggregate levels sufficient to support the associated credit, market, liquidity, reputational, operational, and legal risks.

Examiners should review the substance of securitizations when assessing underlying risk exposures. For example, partial, first-loss direct credit substitutes providing credit protection to a securitization transaction can, in substance, involve the same credit risk as would be involved in holding the entire asset pool on the institution's balance sheet. Under current rules, however, regulatory capital is explicitly required only against the amount of the direct credit substitute, which can be significantly different from the amount of capital that the institution should maintain against the concentrated credit risk in the guarantee. Examiners should ensure that banking organizations have implemented reasonable methods for allocating capital against the economic substance of credit exposures arising from early amortization events and liquidity facilities associated with securitized transactions. These liquidity facilities are usually structured as short-term commitments in order to avoid a risk-based capital requirement, even though the inherent credit risk may be similar to that of a guarantee.[5]

If, in the examiner's judgment, an institution's capital level is not sufficient to provide protection against potential losses from such credit exposures, this deficiency should be reflected in the banking organization's CAMELS rating. Furthermore, examiners should discuss the capital deficiency with the institution's management and, if necessary, its board of directors. Such an institution will be expected to develop and implement a plan for strengthening the organization's overall capital adequacy to levels deemed appropriate given all the risks to which it is exposed.

RISK-BASED CAPITAL PROVISIONS AFFECTING ASSET SECURITIZATION

The risk-based capital framework assigns risk weights to loans, ABS, off-balance-sheet credit enhancements, and other assets related to securitization.[6] Second, bank holding companies that transfer assets with recourse to the seller as part

4. Note, however, that it is the Federal Reserve's Regulation D (12 CFR 204) that defines what constitutes a reservable liability of a depository institution. Thus, although a given transaction may qualify as an asset sale for call report purposes, it nevertheless could result in a reservable liability under Regulation D. See the call report instructions for further guidance. Also, refer to section 3020.1, "Assessment of Capital Adequacy."

5. For further guidance on distinguishing, for risk-based capital purposes, whether a facility is a short-term commitment or a direct credit substitute, see SR-92-11, "Asset-Backed Commercial Paper Programs." Essentially, facilities that provide liquidity, but which also provide credit protection to secondary-market investors, are to be treated as direct credit substitutes for purposes of risk-based capital.

6. In addition to being subject to risk-based capital requirements, servicing assets are also subject to capital limitations. The total amount of servicing assets (including both mortgage-servicing assets and nonmortgage-servicing assets) and purchased credit-card relationships that may be included in a bank's capital may not, in aggregate, exceed 100 percent of tier 1 capital. The total amount of nonmortgage-servicing assets and purchased credit-card relationships is subject to a separate aggregate sublimit of 25 percent of tier 1 capital.

of the securitization process will now be explicitly required to hold capital against their off-balance-sheet credit exposures. However, the specific capital requirement will depend on the amount of recourse retained by the transferring institution and the type of asset sold with recourse. Third, banking organizations that provide credit enhancement to asset securitization issues through standby letters of credit or by other means will have to hold capital against the related off-balance-sheet credit exposure.

The risk weights assigned to an asset-backed security generally depend on the issuer and on whether the assets that compose the collateral pool are mortgage-related assets or guaranteed by a U.S. government agency. ABS issued by a trust or a single-purpose corporation and backed by nonmortgage assets generally are to be assigned a risk weight of 100 percent.

Securities guaranteed by U.S. government agencies and those issued by U.S. government–sponsored agencies are assigned risk weights of 0 percent and 20 percent, respectively, because of the low degree of credit risk. Accordingly, mortgage pass-through securities guaranteed by GNMA are placed in the risk category of 0 percent. In addition, securities such as participation certificates and CMOs issued by FNMA or FHLMC are assigned a 20 percent risk weight.

However, several types of securities issued by FNMA and FHLMC are excluded from the lower risk weight and slotted in the 100 percent risk category. Residual interests (for example, CMO residuals) and subordinated classes of pass-through securities or CMOs that absorb more than their pro rata share of loss are assigned to the 100 percent risk-weight category. Furthermore, high-risk mortgage derivative securities and all stripped, mortgage-backed securities, including IOs, POs, and similar instruments, are also assigned to the 100 percent risk-weight category because of their high price volatility and market risk.

A privately issued mortgage-backed security that meets the criteria listed below is considered a direct or indirect holding of the underlying mortgage-related assets and is generally assigned to the same risk category as those assets (for example, U.S. government agency securities, U.S. government–sponsored agency securities, FHA- and VA-guaranteed mortgages, and conventional mortgages). However, under no circumstances will a privately issued mortgage-backed security be assigned to the 0 percent risk category. Therefore, private issues that are backed by GNMA securities will be assigned to the 20 percent risk category as opposed to the 0 percent category appropriate to the underlying GNMA securities. The criteria that a privately issued mortgage-backed security must meet to be assigned the same risk weight as the underlying assets are as follows:

- The underlying assets are held by an independent trustee, and the trustee has a first priority, perfected security interest in the underlying assets on behalf of the holders of the security.
- The holder of the security has an undivided pro rata ownership interest in the underlying mortgage assets, or the trust or single-purpose entity (or conduit) that issues the security has no liabilities unrelated to the issued securities.
- The cash flow from the underlying assets of the security in all cases fully meets the cash-flow requirements of the security without undue reliance on any reinvestment income.
- No material reinvestment risk is associated with any funds awaiting distribution to the holders of the security.

Those privately issued mortgage-backed securities that do not meet the above criteria are to be assigned to the 100 percent risk category.

If the underlying pool of mortgage-related assets is composed of more than one type of asset, then the entire class of mortgage-backed securities is assigned to the category appropriate to the highest risk-weighted asset in the asset pool. For example, if the security is backed by a pool consisting of U.S. government–sponsored agency securities (for example, FHLMC participation certificates) that qualify for a 20 percent risk weight and conventional mortgage loans that qualify for the 50 percent risk category, then the security would receive the 50 percent risk weight.

While not set forth specifically in the risk-based capital guidelines, student loan–backed securities that meet the above-mentioned criteria may also be considered an indirect holding of the underlying assets and assigned to the same risk category as those assets. For instance, the U.S. Department of Education conditionally guarantees banks originating student loans for 98 percent of each loan under the Federal Family Education Loan Program. The guaranteed portion of the student loans is eligible for the 20 percent risk category. Therefore, senior asset-backed securities that are supported solely by student loans that are conditionally guaranteed by the Department of Education and which meet the four criteria listed above may be assigned to the 20 percent risk category to the extent they are guaranteed. As with mortgage-backed securities, subordinated student loan–backed securities and securities backed by pools of conditionally guaranteed and nonguaranteed student loans would be assigned to the 100 percent risk category.

Banks report their activities in accordance with GAAP, which permits asset securitization transactions to be treated as sales when certain criteria are met even when there is recourse to the seller. In accordance with the RBC guideline, banks are required to hold capital against the off-balance-sheet credit exposure arising from the contingent liability associated with the recourse provisions. This exposure, generally the outstanding principal amount of the assets sold with recourse, is considered a direct credit substitute that is converted at 100 percent to an on-balance-sheet credit-equivalent amount for appropriate risk weighting.

A banking organization that contractually limits its maximum recourse obligation to an amount less than the full effective risk-based capital requirement for the transferred assets is required to hold risk-based capital equal to the maximum amount of the recourse obligation.[7] Thus, a banking organization's capital requirement on low-level recourse transactions would not exceed the maximum contractual amount it could lose under the recourse obligation. This capital treatment applies to low-level recourse transactions involving all types of assets, including commercial loans and residential mortgages.

Low-level recourse transactions may arise when a bank sells or securitizes assets and uses contractual cash flows, such as spread accounts and interest-only strip receivables, as credit enhancement for the sold or securitized assets. A spread account is an escrow account that a bank typically establishes to absorb losses on receivables it has sold in a securitization, thereby providing credit enhancement to investors in the securities backed by the receivables, for example, credit card receivables. As defined in FASB Statement No. 125, ''Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,'' an interest-only strip receivable is the contractual right to receive some or all of the interest due on a bond, a mortgage loan, or other interest-bearing financial assets, including the rights to future interest cash flows that exceed contractually specified servicing fees on assets that have been sold.

Another divergence from the general risk-based capital treatment for assets sold with recourse concerns small-business obligations. Qualifying institutions that transfer small-business obligations with recourse are required, for risk-based capital purposes, to maintain capital only against the amount of recourse retained, provided two conditions are met. First, the transactions must be treated as a sale under GAAP, and second, the transferring institutions must establish, pursuant to GAAP, a noncapital reserve sufficient to meet the reasonably estimated liability under their recourse arrangements.

Banking organizations will be considered qualifying if, pursuant to the Board's prompt-corrective-action regulation (12 CFR 208.30), they are well capitalized or, by order of the Board, adequately capitalized.[8] To qualify, an institution must be determined to be well capitalized or adequately capitalized without taking into account the preferential capital treatment for any previous transfers of small-business obligations with recourse. The total outstanding amount of recourse retained by a qualifying banking organization on transfers of small-business obligations receiving the preferential capital treatment cannot exceed 15 percent of the institution's total risk-based capital.

Banking organizations that issue standby letters of credit as credit enhancements for ABS

7. For example, the effective risk-based capital requirement generally would be 4 percent for residential mortgages and 8 percent for commercial loans.

8. Under 12 CFR 208.33, a state member bank is deemed to be well capitalized if it (1) has a total risk-based capital ratio of 10.0 percent or greater; (2) has a tier 1 risk-based capital ratio of 6.0 percent or greater; (3) has a leverage ratio of 5.0 percent or greater; and (4) is not subject to any written agreement, order, capital directive, or prompt-corrective-action directive issued by the Board pursuant to section 8 of the FDI Act, the International Lending Supervision Act of 1983, or section 38 of the FDI Act or any regulation thereunder to meet and maintain a specific capital level for any capital measure.

A state member bank is deemed to be adequately capitalized if it (1) has a total risk-based capital ratio of 8.0 or greater, (2) has a tier 1 risk-based capital ratio of 4.0 percent or greater, (3) has a leverage ratio of 4.0 percent or greater or a leverage ratio of 3.0 percent or greater if the bank is rated composite 1 under the CAMELS rating system in its most recent examination and is not experiencing or anticipating significant growth, and (4) does not meet the definition of a well-capitalized bank.

issues must hold capital against these contingent liabilities under the risk-based capital guidelines. According to the guidelines, financial standby letters of credit are direct credit substitutes, which are converted in their entirety to credit-equivalent amounts. The credit-equivalent amounts are then risk weighted according to the type of counterparty or, if relevant, to any guarantee or collateral.

SOUND RISK-MANAGEMENT PRACTICES

Examiners should verify that an institution incorporates the risks involved in its securitization activities into its overall risk-management system. The system should entail (1) inclusion of risk exposures in reports to the institution's senior management and board to ensure proper management oversight; (2) adoption of appropriate policies, procedures, and guidelines to manage the risks involved; (3) appropriate measurement and monitoring of risks; and (4) assurance of appropriate internal controls to verify the integrity of the management process with respect to these activities. The formality and sophistication of an institution's risk-management system should be commensurate with the nature and volume of its securitization activities. Institutions with significant activities in this area are expected to have more elaborate and formal approaches to manage the risk of their securitization activities.

Board and Senior Management Oversight

Both the board of directors and senior management are responsible for ensuring that they fully understand the degree to which the organization is exposed to the credit, market, liquidity, operational, legal, and reputational risks involved in the institution's securitization activities. They are also responsible for ensuring that the formality and sophistication of the techniques used to manage these risks are commensurate with the level of the organization's activities. The board should approve all significant policies relating to the management of risk arising from securitization activities and should ensure that risk exposures are fully incorporated in board reports and risk-management reviews.

Policies and Procedures

Senior management is responsible for ensuring that the risks arising from securitization activities are adequately managed on both a short-term and long-run basis. Management should ensure that there are adequate policies and procedures in place for incorporating the risk of these activities into the overall risk-management process of the institution. Such policies should ensure that the economic substance of the risk exposures generated by these activities is fully recognized and appropriately managed. In addition, banking organizations involved in securitization activities should have appropriate policies, procedures, and controls for underwriting asset-backed securities; funding the possible return of revolving receivables (for example, credit card receivables and home equity lines); and establishing limits on exposures to individual institutions, types of collateral, and geographic and industrial concentrations.

Risk Measurement and Monitoring

An institution's management information and risk-measurement systems should fully incorporate the risks involved in its securitization activities. Banking organizations must be able to identify credit exposures from all securitization activities, as well as measure, quantify, and control those exposures on a fully consolidated basis. The economic substance of the credit exposures of securitization activities should be fully incorporated into the institution's efforts to quantify its credit risk, including efforts to establish more formal grading of credits to allow for statistical estimation of loss-probability distributions. Securitization activities should also be included in any aggregations of credit risk by borrower, industry, or economic sector.

An institution's information systems should identify and segregate those credit exposures arising from the institution's loan-sale and securitization activities. Such exposures include the sold portions of participations and syndications, exposures arising from the extension of credit enhancement and liquidity facilities, the effects of an early amortization event, and the investment in asset-backed securities. The management reports should provide the board and senior management with timely and sufficient information to monitor the institution's exposure limits and overall risk profile.

Stress Testing

The use of stress testing, including combinations of market events that could affect a banking organization's credit exposures and securitization activities, is another important element of risk management. Stress testing involves identifying possible events or changes in market behavior that could have unfavorable effects on the institution and assessing the organization's ability to withstand them. Stress testing should consider not only the probability of adverse events but also likely worst-case scenarios. Stress testing should be done on a consolidated basis and should consider, for instance, the effect of higher-than-expected levels of delinquencies and defaults, as well as the consequences of early amortization events with respect to credit card securities, that could raise concerns regarding the institution's capital adequacy and its liquidity and funding capabilities. Stress-test analyses should also include contingency plans for possible management actions in certain situations.

Internal Controls

One of management's most important responsibilities is establishing and maintaining an effective system of internal controls. Among other things, internal controls should enforce the official lines of authority and the appropriate separation of duties in managing the risks of the institution. These internal controls must be suitable for the type and level of risks at the institution, given the nature and scope of its activities. Moreover, these internal controls should ensure that financial reporting is reliable (in published financial reports and regulatory reports), including adequate allowances or liabilities for expected losses.

UNDERWRITING AND DEALING IN SECURITIES

Member banks may underwrite and deal in obligations of the United States, general obligations of states and political subdivisions, and certain securities issued or guaranteed by government agencies (12 USC 335 and 12 USC 24). Bank holding companies may underwrite and deal in U.S. government and in agency, state, and municipal securities and other obligations that state member banks are authorized to underwrite and deal in under section 16 of the Glass-Steagall Act (referred to as ''eligible securities''), as authorized by section 225.28(b)(8)(i) of Regulation Y. By Board order, beginning in 1987, certain bank holding company nonbanking subsidiaries were given the authority to underwrite and deal in ''ineligible securities'' that member banks may not underwrite and deal in, specifically—

- municipal revenue bonds, including so-called ''public ownership'' industrial development bonds (tax-exempt bonds in which the governmental issuer or the government unit on behalf of which the bonds are issued is the owner, for federal income tax purposes, of the financed facility, such as airports, mass commuting facilities, and water pollution control facilities),
- mortgage-related securities (obligations secured by or representing an interest in one- to four-family residential real estate),
- consumer receivable–related securities, and
- ''prime quality'' commercial paper.

In January 1989, certain bank holding company section 20 nonbanking subsidiaries were also approved to underwrite and deal in debt or equity securities (excluding open-end investment companies). The Board, however, required that each applicant establish the necessary managerial and operational infrastructure before receiving Board authorization to commence the expanded underwriting and dealing activity. All bank holding companies having section 20 Board orders are subject to specific conditions (''firewalls'') as stated within their respective orders.

On September 21, 1989, the Board approved an order (FRB 751(1989)) giving bank holding company subsidiaries the ability to underwrite and deal in securities of affiliates, consistent with section 20 of the Glass-Steagall Act, if the securities—

- are rated by an unaffiliated, nationally recognized statistical rating organization; or
- are issued or guaranteed by the FNMA, FHLMC, or GNMA, or they represent interests in such obligations.

For a more detailed description of underwriting and bank dealer activities, see section 2030.1, ‘‘Bank Dealer Activities.’’

The securitization power of national banks was reaffirmed by the Supreme Court on February 20, 1990, when the Supreme Court let stand a court of appeals ruling that permits national banks to package and sell mortgage loans as securities. The ruling confirms that national banks can not only sell but also underwrite mortgage-backed securities from mortgage loans that they originate (Securities Industry Association v. Clarke, 885 F.2d 1034 (2d Cir. 1989), cert. denied, 110 S.Ct. 1113(1990)).

SECURITIZATION OF COMMERCIAL PAPER

The involvement of banks in the securitization of commercial paper has increased significantly over time. It is important to note, however, that asset-backed commercial paper programs differ from other methods of securitization. One difference is that more than one type of asset may be included in the receivables pool.[9] Moreover, in certain cases, the cash flow from the receivables pool may not necessarily match the payments to investors because the maturity of the underlying asset pool does not always parallel the maturity of the structure of the commercial paper. Consequently, when the paper matures, it is usually rolled over, or funded by another issue. In certain circumstances, a maturing issue of commercial paper cannot be rolled over. To address this problem, many banks have established back-up liquidity facilities. Certain banks have classified these back-up facilities as pure liquidity facilities, despite the credit enhancement element present in them, and, as a result, have incorrectly assessed the risks associated with these facilities. In these cases, the back-up liquidity facilities have been more similar to direct credit substitutes than to loan commitments.

9. See the Federal Reserve System’s Supervision and Regulation Task Force on Securitization, ‘‘An Introduction to Asset Securitization,’’ issued as an attachment to SR-90-16, and ‘‘Asset-Backed Commercial Paper Programs,’’ *Federal Reserve Bulletin*, February 1992.

APPRAISALS AND MORTGAGE-BACKED SECURITIES

Under 12 CFR 225.63(a)(8), an appraisal performed by a state-certified or -licensed appraiser is not required for any real estate–related financial transaction in which a regulated institution purchases a loan or interest in a loan, pooled loans, or interest in real property, including mortgage-backed securities, provided that the appraisal prepared for each pooled loan or real property interest met the requirements of the regulation. Banks must establish procedures for determining and ensuring that applicable appraisals meet the requirements.

EXAMINATION GUIDELINES FOR ASSET SECURITIZATION

A banking organization may be involved in originating the assets to be pooled, packaging the assets for securitization, servicing the pooled assets, acting as trustee for the pool, providing credit enhancements, underwriting or placing the ABS, or investing in the securities. Individual securitization arrangements often possess unique features and the risks addressed in this abbreviated version of the examiner guidelines[10] do not apply to all securitization arrangements; conversely, arrangements may entail risks not summarized here. Examiners should judge a banking organization’s exposure to securitization with reference to the specific structures in which the organization is involved and the degree to which the organization has identified exposures and has implemented policies and controls to manage them. Examiners may tailor the scope of their examinations if the banking organization’s involvement in securitization is immaterial relative to its size and financial strength.

A banking organization participating in securitization, in any capacity, should ensure that the activities are clearly and logically integrated into the overall strategic objectives of the organization. The management of the organization should understand the risks and should not rely

10. A complete version of the ‘‘Examination Guidelines for Asset Securitization’’ is attached to SR-90-16.

excessively on outside expertise to make crucial decisions regarding securitization activities.

As mentioned earlier, the degree of securitization exposure faced by an individual banking organization depends on the role of the organization in the securitization process. An organization involved in the issuance of ABS as originator, packager, servicer, credit enhancer, underwriter, or trustee may face combinations and degrees of risk different from those faced by an organization that only invests in ABS. Examiners should assess a banking organization's level, identification, and management of risks within the context of its roles.

A banking organization should conduct an independent analysis of its exposures before participating in any aspect of securitization and should continue to monitor its exposures throughout its involvement. The analysis and subsequent monitoring should take into account the entire securitization arrangement, emphasizing different risks according to the role that the organization plays. Excessive reliance on opinions of third parties and reported collateral values should be avoided.

An organization involved in the issuance of ABS should scrutinize the underlying assets, giving consideration to their yield, maturity, credit risk, prepayment risk, and the accessibility of collateral in cases of default, as well as the structure of the securitization arrangement and the ability of the other participants in the transaction to meet their obligations. On the other hand, a banking organization investing in ABS can be expected to place greater emphasis on the characteristics of the ABS as securities, paying attention primarily to credit risk, prepayment risk, liquidity risk, and concentration risk; the underlying assets and structure of the securitization arrangement would be evaluated only within this context.

Appropriate policies, procedures, and controls should be established by a banking organization before participating in asset securitization. Controls should include well-developed management information systems. In addition, significant policies and procedures should be approved and reviewed periodically by the organization's board of directors.

In addition to evaluating and monitoring exposure to particular securitization deals, a banking organization should manage its overall exposure on a consolidated holding company basis. Management of these exposures should include—

- reasonable limits on geographic and industrial concentrations, as well as on exposures to individual institutions;
- internal systems and controls to monitor these exposures and provide periodic and timely reports to senior management and the board of directors on performance and risks; and
- procedures for identifying potential or actual conflicts of interest and policies for resolving those conflicts.

The following general guidelines are intended to help examiners assess the exposures of banks and bank holding companies to asset securitization.

Banking Organizations Involved in Issuing or Managing ABS

A banking organization involved in the issuance of ABS as originator, packager, servicer, credit enhancer, underwriter, or trustee should analyze the assets underlying the asset-backed security and the structure of the arrangement, including—

- the characteristics and expected performance of the underlying assets,
- the banking organization's ability to meet its obligations under the securitization arrangement, and
- the ability of the other participants in the arrangement to meet their obligations.

Analysis of the underlying assets should be conducted independently by each participant in the process, giving consideration to yield, maturity, credit risk, prepayment risk, and the accessibility of collateral in cases of default. An originator should further consider the impact of securitization on the remaining asset portfolio and on the adequacy of loan-loss reserves and overall capital.

Financial position and operational capacity should be adequate to meet obligations to other parties in a securitization arrangement, even under adverse scenarios. Accordingly, a banking organization should ensure that the pricing of services is adequate to cover costs over the term of the obligation, as well as to compensate for associated risks. Further, the organization should have contingency plans to transfer responsibilities to another institution in the event that those responsibilities can no longer be fulfilled.

Examiners should determine that the banking organization has policies and controls for managing contractual obligations, including management of collateral, if applicable. Staffing levels should be adequate to fulfill responsibilities.

If a banking organization's obligations, under a securitization agreement, are subcontracted to other parties, an assessment of the subcontractor's financial position and operational capacity should be conducted before delegating responsibility. Further, the subcontractor's financial position and compliance with contractual obligations should be monitored periodically.

A banking organization involved in issuing ABS should assess the ability of other participants in the securitization arrangement to meet their obligations, considering obligations that they may have under other securitization arrangements. The rights and obligations of each of the participants under possibly novel legal and institutional arrangements should be clearly documented.

Funding and liquidity management for originators and packagers of securitized assets should avoid excessive reliance on the device of securitization. Originators and packagers should monitor the securitization market closely, develop a broad customer base for their securitization activities, and maintain diversified funding sources.

Banking organizations should not rely excessively on the expertise of a single individual or a small group of individuals, either inside or outside the organization, for the management of participation in securitization activities.

Examiners should ensure that an organization acting as trustee for ABS follows the usual standards for trust services.

Policy and Portfolio Analysis

Credit risk. Institutions should be aware that the credit risk involved in many securitization activities may not always be obvious. For certain types of loan-sales and securitization transactions, a banking organization may actually be exposed to essentially the same credit risk as in traditional lending activities, even though a particular transaction may, superficially, appear to have isolated the institution from any risk exposure. In such cases, removal of an asset from the balance sheet may not result in a commensurate reduction in credit risk. Transactions that can give rise to such instances include loan sales with recourse; credit derivatives; direct credit substitutes, such as letters of credit; and liquidity facilities extended to securitization programs, as well as certain asset securitization structures, such as the structure typically used to securitize credit card receivables.

The partial, first-loss recourse obligations an institution retains when selling assets, and the extension of partial credit enhancements (for example, 10 percent letters of credit) in connection with asset securitization, can be sources of concentrated credit risk by exposing institutions to the full amount of expected losses on the protected assets. For instance, the credit risk associated with whole loans or pools of assets that are sold to secondary-market investors can often be concentrated within the partial, first-loss recourse obligations retained by the banking organizations selling and securitizing the assets. In these situations, even though institutions may have reduced their exposure to catastrophic loss on the assets sold, they generally retain the same credit-risk exposure that they would have had if they continued to hold the assets on their balance sheets.

In addition to recourse obligations, institutions assume concentrated credit risk through the extension of partial direct credit substitutes, such as through the purchase (or retention) of subordinated interests in their own asset securitizations or through the extension of letters of credit. For example, banking organizations that sponsor certain asset-backed commercial paper programs, or so-called ''remote-origination'' conduits, can be exposed to high degrees of credit risk even though it may seem that their notional exposure is minimal. A remote-origination conduit lends directly to corporate customers referred to it by the sponsoring banking organization that used to lend directly to these same borrowers. The conduit funds this lending activity by issuing commercial paper that, in turn, is guaranteed by the sponsoring banking organization. The net result is that the sponsoring institution has much the same credit-risk exposure through this guarantee that it would have had if it had made the loans directly and held them on its books. This is an off-balance-sheet transaction, however, and its associated risks may not be fully reflected in the institution's risk-management system.

Furthermore, banking organizations that extend liquidity facilities to securitized transactions, particularly to asset-backed commercial paper programs, may be exposed to high degrees of credit risk which may be subtly embedded within a facility's provisions. Liquidity facilities are commitments to extend short-term credit to cover temporary shortfalls in cash flow. While all commitments embody some degree of credit risk, certain commitments extended to asset-backed commercial paper programs to provide liquidity may subject the extending institution to the credit risk of the underlying asset pool, often trade receivables, or of a specific company using the program for funding. Often, the stated purpose of these liquidity facilities is to provide funds to the program to retire maturing commercial paper when a mismatch occurs in the maturities of the underlying receivables and the commercial paper, or when a disruption occurs in the commercial paper market. However, depending on the provisions of the facility—such as whether the facility covers dilution of the underlying receivable pool—credit risk can be shifted from the program's explicit credit enhancements to the liquidity facility.[11] Such provisions may enable certain programs to fund riskier assets and yet maintain the credit rating on the program's commercial paper without increasing the program's credit-enhancement levels.

The structure of various securitization transactions can also result in an institution's retaining the underlying credit risk in a sold pool of assets. Examples of this contingent credit-risk retention include credit card securitizations in which the securitizing organization explicitly sells the credit card receivables to a master trust, but, in substance, retains the majority of the economic risk of loss associated with the assets because of the credit protection provided to investors by the excess yield, spread accounts, and structural provisions of the securitization. Excess yield provides the first level of credit protection that can be drawn upon to cover cash shortfalls between the principal and coupon owed to investors and the investors' pro rata share of the master trust's net cash flows. The excess yield is equal to the difference between the overall yield on the underlying credit card portfolio and the master trust's operating expenses.[12] The second level of credit protection is provided by the spread account, which is essentially a reserve funded initially from the excess yield.

In addition, the structural provisions of credit card securitizations generally provide credit protection to investors through the triggering of early amortization events. Such an event usually is triggered when the underlying pool of credit card receivables deteriorates beyond a certain point and requires that the outstanding credit card securities begin amortizing early to pay off investors before the prior credit enhancements are exhausted. As the early amortization accelerates the redemption of principal (paydown) on the security, the credit card accounts that were assigned to the master credit-card trust return to the securitizing institution more quickly than had originally been anticipated. Thus, the institution is exposed to liquidity pressures and any further credit losses on the returned accounts.

Examiner procedures for reviewing credit risk are outlined below:

- Examiners should review a banking organization's policies and procedures to ensure that the organization follows prudent standards of credit assessment and approval for all securitization exposure. Procedures should include an initial thorough and independent credit assessment of each loan or pool for which it has assumed credit risk, followed by periodic credit reviews to monitor performance throughout the life of the exposure.
- Examiners should determine that rigorous credit standards are applied, regardless of the role an organization plays in the issuance of ABS. The servicer, credit enhancer, and underwriter must perform assessments and approvals independent of and distinct from reviews provided by the originator or packager.
- Major policies and procedures, including internal credit-review and -approval procedures and in-house exposure limits, should be reviewed periodically and approved by the institution's board of directors.
- Failure, fraud, or mismanagement on the part of one participant in an ABS issue could result in loss to any of the other institutions involved

11. Dilution essentially occurs when the receivables in the underlying asset pool—before collection—are no longer viable financial obligations of the customer. For example, dilution can arise from returns of consumer goods or unsold merchandise by retailers to manufacturers or distributors.

12. The monthly excess yield is the difference between the overall yield on the underlying credit card portfolio and the master trust's operating expenses. It is calculated by subtracting from the gross portfolio yield (1) the coupon paid to investors, (2) charge-offs for that month, and (3) a servicing fee, usually 200 basis points paid to the banking organization sponsoring the securitization.

in the issue. A banking organization involved in securitization should have adequate procedures for evaluating the internal control procedures and financial strength of other institutions with which it is involved.

- Securitization arrangements may remove a credit enhancer from direct access to the collateral. The remedies available to a banking organization involved in the provision of credit enhancement in the event of a default should be clearly documented.
- Examiners should ensure that, regardless of the role an institution plays in securitization, ABS documentation clearly specifies the limitations of the institution's legal responsibility to assume losses.
- Examiners should verify that a banking organization acting as originator, packager, or underwriter has written policies addressing the repurchase of assets and other reimbursement to investors in the event that a defaulted package results in losses exceeding any contractual credit enhancement. A banking organization that repurchases defaulted assets or pools in contradiction of the underlying agreement in effect sets a standard by which it could potentially be found legally liable for all ''sold'' assets. Examiners should, therefore, review any situations in which the organization has repurchased or otherwise reimbursed investors for poor-quality assets.
- A banking organization's records should be reviewed to ensure that credit, pricing, and servicing standards for securitized assets are equivalent to standards for assets that remain on the books. The quality of securitized assets should be accurately characterized to investors and other parties to the securitization arrangement to avoid unforeseen pressures to repurchase defaulted issues.
- Pricing policies and practices should be reviewed to determine that they incorporate an analysis of the trade-off between risk and return.
- Examiners should consider securitization risks when analyzing the adequacy of an organization's capital or reserve levels. Adverse credit risk should be classified accordingly.

Concentration risk. A banking organization involved in originating, packaging, servicing, underwriting, or credit enhancing ABS must take special care to follow in-house diversification requirements for aggregate outstandings to a particular institution, industry, or geographic area. Examiner procedures for reviewing concentration risk are outlined below:

- When determining compliance with internal credit-exposure limits, securitization exposure should be aggregated with all loans, extensions of credit, debt and equity securities, legally binding financial guarantees, commitments, and any other investments involving the same obligor.
- Examiners should review all pools of sold assets for industrial or geographic concentrations. Excessive exposures to an industry or region among these assets should be noted in the review of the banking organization's loan portfolio.
- Inherent in securitization is the risk that, if another party involved in the securitization arrangement becomes unable to perform according to contract terms, the issue might default even while the underlying credits are performing. This credit exposure to the other managing parties in a securitization transaction should be included under a banking organization's general line to those institutions. Examiners should, therefore, ensure that, in addition to policies limiting direct credit exposure, an institution has developed exposure limits, with respect to particular originators, credit enhancers, and servicers.

Reputational risk. The securitization activities of many institutions may also expose them to significant reputational risks. Often, banking organizations that sponsor the issuance of asset-backed securities act as servicers, administrators, or liquidity providers in the securitization transactions. These institutions must be aware of the potential losses and risk exposure associated with reputational risk that arise from these securitization activities. The securitization of assets whose performance has deteriorated may result in a negative market reaction that could increase the spreads on an institution's subsequent issuances. To avoid a possible increase in their funding costs, institutions have supported their securitization transactions by improving the performance of the securitized asset pool (for example, by selling discounted receivables or adding higher-quality assets to the securitized asset pool). Thus, an institution's voluntary support of its securitization in order to protect its reputation can adversely affect the sponsoring or issuing organization's earnings and capital.

Liquidity and market risk. The existence of recourse provisions in asset sales, extension of liquidity facilities to securitization programs, and early amortization triggers of certain asset securitization transactions can involve significant liquidity risk to institutions engaged in these securitization activities. Institutions should ensure that their liquidity contingency plans fully incorporate the potential risk posed by their securitization activities. When new asset-backed securities are issued, the issuing banking organization should determine their potential effect on its liquidity at the inception of each transaction and throughout the life of the securities to better ascertain its future funding needs.

An institution's contingency plans should consider the need to obtain replacement funding and specify the possible alternative funding sources, in the event of the amortization of outstanding asset-backed securities. Replacement funding is particularly important for securitizations of revolving receivables, such as credit cards, in which an early amortization of the asset-backed securities could unexpectedly return the outstanding balances of the securitized accounts to the issuing institution's balance sheet. Early amortization of a banking organization's asset-backed securities could impede an institution's ability to fund itself—either through reissuance or other borrowings—since the institution's reputation with investors and lenders may be adversely affected. Moreover, the liquidity risk and market risk to which ABS are subject may be exacerbated by thin secondary markets for them. Examiner procedures for reviewing liquidity and market risk are outlined below:

- Examiners should review the policies of a banking organization engaged in underwriting, looking for situations in which it cannot sell underwritten ABS. Credit review, funding capabilities, and approval limits should allow the institution to purchase and hold unsold securities. Absent this analysis, the institution should only handle ABS on a best-efforts basis. All potential credit exposure should be within legal lending limits.
- Examiners should ensure that a banking organization engaged in underwriting or market making has implemented adequate hedging or other risk-management policies to limit its exposure to adverse price movements.
- Examiners should determine whether an organization targets certain loans at origination to be packaged and securitized. If so, examiners should review the length of time these assets are held while being processed. Examiners should review management information systems reports to age targeted loans and to determine if there is any decline in value while the loans are in the pipeline. Loans held for resale in this pipeline should be segregated and carried at the lower of cost or market value.

Transfer risk and operational risk. Transfer risk is analogous to liquidity risk. It is the risk that an organization with obligations under securitization arrangements may wish to relinquish those obligations but may not be able to do so. Operational risk arises from uncertainty about an organization's ability to meet its obligations under securitization arrangements and may arise from insufficient computer resources or from a failure of fees to cover associated costs. An organization filling a role that potentially requires long-term resource commitments, such as servicer or credit enhancer, is most susceptible to transfer risk and operational risk. Examiner procedures for reviewing transfer and operational risk are outlined below:

- Examiners should determine that a banking organization has reviewed the relevant contracts to verify that they are free of any unusual features that increase the potential cost of transfer of obligations.
- Examiners should ascertain that a banking organization has evaluated the fee structure of the securitization to determine that fees are sufficient to cover the costs of associated services. Further, examiners should determine that a banking organization has reviewed the projected cash flow from the underlying assets to ensure that principal and interest payments will be timely and will be sufficient to cover costs, even under adverse scenarios.
- A servicer or credit enhancer subcontracting or participating responsibilities should initially assess the financial condition and reputation of any organization to which responsibility may be delegated. Subsequent periodic monitoring by the servicer or credit enhancer should assess the financial condition of organizations to which responsibility has been delegated, as well as their compliance with contractual obligations. Trustees should, likewise, monitor the financial condition and compliance of all participants in the securitization arrangement.

Conflicts of interest. With respect to the various functions performed by a banking organization, the potential for conflicts of interest exists when an organization plays multiple roles in securitization. Policies and procedures must address this potential conflict, especially the risk of legal ramifications or negative market perceptions if the organization appears to compromise its fiduciary responsibility to obligors or investors. Examiner procedures for reviewing conflicts of interest are outlined below:

- Examiners should review a banking organization's policies for disclosure of confidential but pertinent information about the underlying assets and obligors. An organization involved in the origination or processing of a securitization transaction should have written statements from obligors allowing the disclosure of pertinent confidential information to potential investors. In addition, the underwriting bank must follow proper procedures of due diligence.
- If the securitization business of an originator, underwriter, or credit enhancer is volume-driven, legal obligations or prudent banking practices may be breached. Examiners should review credit standards used in analyzing assets earmarked for securitization to determine that sound banking practices are not being compromised to increase volume or to realize substantial fees.
- Examiners should determine that the organization's policies addressing activities at various subsidiaries or affiliates are managed consistently and prudently in compliance with regulatory policies.

Legal Review and Liability

The complexity of asset securitization transactions requires a banking organization that participates in them in any capacity to fully investigate all applicable laws and regulations, to establish policies and procedures to ensure legal review of all securitization activities, and to take steps to protect the organization from liability in the case of problems with particular asset-backed issues. Organizations and examiners should be aware of the continual evolution of criteria on the types of assets that may be securitized and the types of banking organizations that may engage in the various aspects of securitization. Examiner procedures for checking an institution's legal-review and liability-protection measures are outlined below:

- Different responsibilities in connection with securitizations may be split among various subsidiaries of an organization. Examiners should, therefore, review the overall risk exposure to an organization. Specifically, examiners should be alert to situations in which the structure of a securitization effectively conceals low-quality assets or contingent liabilities from examination scrutiny and possible classification.
- Examiners should review a banking organization's insurance coverage to determine if it is sufficient to cover its fiduciary responsibilities under securitization arrangements. At least one rating agency requests that servicers carry errors and omissions insurance that will cover a minimum of 5 percent of the outstanding obligation.
- Private placements of ABS are not subject to the same legal disclosure requirements as public placements. An organization involved in private placements of ABS should, therefore, exercise special caution with regard to disclosure of the risks and attributes of the securitized assets.

Banking Organizations Investing in ABS

ABS may appear similar to corporate notes; however, ABS possess many unique characteristics that affect their riskiness as investments. A banking organization should independently analyze all potential risk exposures before investing in ABS and should continue to monitor exposures throughout the life of the ABS. Analyses should focus primarily on characteristics of ABS, such as credit risk, concentrations of exposures, interest-rate risk, liquidity risk, market risk, and prepayment risk. As an integral part of these analyses, a banking organization investing in ABS should evaluate the underlying assets, the participants in the securitization arrangement, and the structure of the securitization arrangement, although it should not be expected to analyze these factors in the same detail as banking organizations involved in the issuance of ABS.

Any purchase of ABS should be consistent with the overall objectives of the organization.

The securities should constitute an integrated component of the investment or hedging plans of the organization and should not be purchased for speculative purposes. A banking organization should not rely on investment or trading strategies, which depend on the existence of liquid secondary ABS markets.

Policy and Portfolio Analysis

Credit risk. While ABS are often insulated, to some extent, from the credit risk of the underlying assets, credit risk is still affected by a number of factors, in addition to the performance of the underlying asset pool. These factors include the ability of the parties involved in the securitization arrangement to fulfill their obligations and the structure of the securitization itself.

In the event of default by obligors or other failure of the securitization structure, access to collateral may be difficult and recourse to the various providers of credit enhancement may be time-consuming and costly. Some forms of credit enhancement may be revocable. Banking organizations should not place undue reliance on collateral values and credit enhancement in evaluating ABS.

In many cases, ratings of the creditworthiness of ABS issues are available from external credit agencies. A banking organization may use credit ratings as a source of information, but should not depend solely on external agencies' evaluations of creditworthiness. Unrated ABS should be subject to particular scrutiny. Examiner procedures for reviewing credit risk are outlined below:

- Examiners should review a banking organization's policies and procedures to ensure that the organization follows prudent standards of credit assessment and has approval criteria for all ABS exposure. Procedures should include an initial thorough and independent credit assessment of ABS issues for which the organization has assumed any degree of credit risk, followed by periodic reviews to monitor performance of the ABS throughout the life of the exposure.
- Examiners should determine that a banking organization does not rely solely upon conclusions of external rating services in evaluating ABS.
- Examiners should determine that a banking organization investing in ABS has independently made use of available documents in evaluating the credit risk of ABS. These documents include indentures, trustee reports, rating-agency bulletins, and prospectuses.
- Examiners should determine that a banking organization investing in privately placed ABS is aware of the differences in disclosure requirements between publicly placed and privately placed securities, and has taken extra steps to obtain and analyze information relevant to the evaluation of holdings of any privately placed ABS.
- Major policies and procedures, including internal credit-review and -approval procedures and in-house exposure limits, should be reviewed periodically and approved by the institution's board of directors.
- Failure, fraud, or mismanagement on the part of another party could result in loss to investors. A banking organization should have adequate procedures for assessing the financial strength and operational capacity of institutions involved in enhancing the credit quality of or managing an ABS issue.
- A banking organization should have procedures for evaluating the structural soundness of securitization arrangements for ABS in which it invests. The degree of investor control over transfer of servicing rights should be clearly delineated.
- Securitization arrangements may remove the ultimate investor from direct access to the collateral; the remedies available to an investor, in the event of default, should be clearly documented.

Concentration risk. Banking organizations may face concentrations of risk within the pool of assets, underlying an individual ABS issue, across different ABS issues, or through combinations of ABS and other credit exposures. Banking organizations that invest in ABS must take special care to follow in-house diversification requirements for aggregate outstandings to a particular institution, industry, or geographic area. Examiner procedures for reviewing concentration risk are outlined below:

- When determining compliance with internal credit-exposure limits, securitization exposure should be aggregated with all loans, extensions of credit, debt and equity securities, legally binding financial guarantees and commitments, and any other investments involving the same obligor.

- Inherent in securitization is the risk that, if another party involved in the transaction becomes unable to perform, according to contract terms, the issue might default, even while the underlying credits are performing. Examiners should, therefore, ensure that, in addition to policies limiting direct credit exposure, an institution has developed exposure limits for particular credit enhancers, servicers, or trustees. Credit exposure to the other managing parties in a securitization should be included under a banking organization's general line to those institutions.
- Examiners should review the ABS portfolio for any industrial or geographic concentrations. Excessive exposures to a particular industry or region within the portfolio should be noted in the examiner's review.

Liquidity risk and market risk. Limited secondary markets may make ABS, especially unrated or innovative ABS, less liquid than many other debt instruments. Examiner procedures for reviewing liquidity and market risk are outlined below:

- If an investing bank is purchasing securitized assets for trading purposes, the examiner should ensure that the trading assets are carried at market value or at the lower of market or book value, and that market values are determined regularly. The risks involved are similar in character to the risks involved in trading other marketable securities. As with any trading activity, the banking organization must take proper steps to analyze market character and depth.
- A banking organization investing in ABS should not depend on secondary-market liquidity for the securities, especially in the case of ABS involving novel structures or innovative types of assets.
- Management information systems should provide management with timely and periodic information on the historical costs, market values, and unrealized gains and losses on ABS held in investment, trading, or resale portfolios.

Prepayment risk. The prepayment of assets underlying ABS may create prepayment risk for an investor in ABS. Prepayment risk may not be adequately reflected in agency ratings of ABS. Examiner procedures for reviewing prepayment risk are outlined below:

- Examiners should determine that a banking organization investing in ABS has analyzed the prepayment risk of ABS issues in its portfolio. Special care should be taken in the analysis of issues involving multiple tranches.
- Prepayment risk for ABS should be incorporated into an organization's net income-at-risk model, if such a model is used.

Legal Review

Examiners should review policies and procedures for compliance with applicable state lending limits and federal law, such as section 5136 of the Revised Codes. These requirements must be analyzed to determine whether a particular ABS issue is considered a single investment or a loan to each of the creditors underlying the pool. Collateralized mortgage obligations may be exempt from this limitation, if they are issued or guaranteed by an agency or instrumentality of the U.S. government.

Internal Audit and Management Information Systems

A banking organization's management of securitization risk depends on timely and accurate information about the organization's exposure being provided to those responsible for monitoring risks. Examiners must be aware that a banking organization's involvement in asset securitization can be very extensive and place significant demands on systems without being readily evident, either as an on-balance-sheet exposure or a contingent liability. System overload or other technical default in the organization's systems could render the organization unable to provide proper monitoring or servicing. While the risk is not clearly associated with the servicer (whose responsibility is long-term and requires ongoing resource commitments), systems breakdowns may have risk implications for the credit enhancer and trustee. Examiners should ensure that internal auditors examine all facets of securitization regularly, as outlined below:

- Examiners should ensure that internal systems and controls adequately track the performance and condition of internal exposures and should monitor the organization's compliance with internal procedures and limits. In addition, adequate audit trails and internal audit coverage should be provided.

- Cost-accounting systems should be adequate to permit a reliable determination of the profitability and volatility of asset securitization activities.
- Management information systems and reporting procedures should be reviewed to determine that they—
  - — provide a listing of all securitizations for which the banking organization is either originator, servicer, credit enhancer, underwriter, trustee, or investor;
  - — provide concentration listings by industry and geographic area;
  - — generate information on total exposure to specific originators, servicers, credit enhancers, trustees, or underwriters;
  - — generate information on portfolio aging and performance relative to expectations; and
  - — provide periodic and timely information to senior management and directors on the organization's involvement in, and credit exposure arising from, securitization.

ADDITIONAL REFERENCES

The following is a list of accounting literature issued by FASB and the AICPA that relates to asset securitization or asset transfers. This list is current through June 1996.

FASB Statements

FASB Statement No. 5	Accounting for Contingencies
FASB Statement No. 48	Revenue Recognition When Right of Return Exists
FASB Statement No. 65	Accounting for Certain Mortgage Banking Enterprises, as amended
FASB Statement No. 66	Accounting for Sales of Real Estate
FASB Statement No. 77	Reporting by Transferors for Transfers of Receivables with Recourse
FASB Statement No. 91	Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases
FASB Statement No. 115	Accounting for Certain Investments in Debt and Equity Securities
FASB Statement No. 122	Accounting for Mortgage-Servicing Rights
FASB Statement No. 125	Accounting for Trustees and Servicing of Financial Assets and Extinguishment of Liabilities

Technical Bulletins

TB 85-2	Accounting for Collateralized Mortgage Obligations
TB 87-3	Accounting for Mortgage Servicing Fees and Rights

EITF (Emerging Issues Task Force) Abstracts

84-15	Grantor trusts consolidation
84-21	Sale of a loan with a partial participation retained
84-30	Sales of loans to special-purpose entities
85-13	Sale of mortgage-service rights on mortgages owned by others
85-20	Recognition of fees for guaranteeing a loan
85-26	Measurement of servicing fees under FASB Statement No. 65 when a loan is sold with servicing retained
85-28	Consolidation issues relating to collateralized mortgage obligations
86-24	Third-party establishment of CMO
86-38	Implications of mortgage prepayments on amortization of servicing rights
86-39	Gains from the sale of mortgage loans with servicing rights retained
87-25	Sales of convertible, adjustable-rate mortgages with contingent repayment agreement
87-34	Sales of mortgage-servicing rights with a subservicing agreement
88-11	Sale of interest-only or principal-only cash flows from loans receivable
88-17	Accounting for fees and costs associated with loan syndications and loan participations
88-20	Difference between initial investment and principal amount of loans in a purchased credit-card portfolio
88-22	Securitization of credit card portfolios
89-4	Collateralized mortgage obligation residuals
89-18	Divestitures of certain investment securities to an unregulated common controlled entity under FIRREA
89-5	Sale of mortgage-loan-servicing rights
90-2	Exchange of interest-only or principal-only securities for a mortgage-backed security
90-18	Effect of a ‘‘Removal of Accounts’’ provision on the accounting for a credit card securitization

93-18 Recognition for impairment of an investment in a collateralized mortgage obligation instrument or in a mortgage-backed interest-only certificate
94-4 Classification of an investment in a mortgage-backed interest-only certificate as held-to-maturity
94-8 Accounting for conversion of a loan into a debt security in a debt restructuring
94-5 Determination of what constitutes all risks and rewards and no significant unresolved contingencies in a sale of mortgage-loan-servicing rights
95-5 Determination of what risks and rewards, if any, can be retained and whether any unresolved contingencies may exist in a sale of mortgage-loan-servicing rights
D-39 Questions related to the implementation of FASB Statement No. 115

AICPA Statements of Position

90-3 Definition of the Term ''Substantially the Same'' for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position
94-6 Disclosure of Certain Significant Risks and Uncertainties

1. To determine if the bank is in compliance with laws, regulations, and policy statements.
2. To determine if the bank has originated, serviced, credit enhanced, served as a trustee for, or invested in securitized assets.
3. To determine that securitization activities are integrated into the overall strategic objectives of the organization.
4. To determine that management has an appropriate level of experience in securitization activities.
5. To ensure that the bank does not hold any asset-backed securities that are inappropriate, given the size of the bank and the sophistication of its operations, for example, IOs and POs.
6. To ensure that all asset-backed securities owned and any assets sold with recourse are properly accounted for on the bank's books and on regulatory reports.
7. To determine that sources of credit risk are understood, properly analyzed, and managed, without excessive reliance on credit ratings by outside agencies.
8. To determine that credit, operational, and other risks are recognized and are addressed through appropriate policies, procedures, management reports, and other controls.
9. To determine if officers are operating in conformance with established bank policies and procedures.
10. To determine that liquidity and market risks are recognized and that the organization is not excessively dependent on securitization as a substitute for funding or as a source of income.
11. To determine that steps have been taken to minimize the potential for conflicts of interest due to securitization.
12. To determine that possible sources of structural failure in securitization transactions are recognized and that the organization has adopted measures to minimize the impact of these failures should they occur.
13. To determine that the organization is aware of the legal risks and uncertainty of various aspects of securitization.
14. To determine that concentrations of exposure in the underlying asset pools, asset-backed securities portfolio, or structural elements of securitization transactions are avoided.
15. To determine that all sources of risk are evaluated at the inception of each securitization activity and are monitored on an ongoing basis.
16. To initiate corrective action if policies, practices, procedures, and/or internal controls are deficient or when violations of laws, regulations, or policy statements are disclosed.

1. a. Request a schedule of all asset-backed securities owned by the bank. Reconcile to subsidiary ledgers of the balance sheet and review credit ratings assigned to these securities by independent rating agencies. Determine that the accounting methods and procedures, at inception and throughout the carrying life, used for these assets are appropriate.
   b. Request and review information on the types and amount of assets that have been securitized by the bank. In addition, request information concerning potential contractual or contingent liability from guarantees, underwriting, and servicing of securitized assets—whether originally securitized by the bank or not—etc.
2. Review the parent company's policies and procedures to ensure that its banking and nonbanking subsidiaries follow prudent standards of credit assessment and approval for all securitization exposure. Procedures should include thorough and independent credit assessment of each loan or pool for which it has assumed credit risk, followed by periodic credit reviews to monitor performance throughout the life of the exposure. If a banking organization invests in asset-backed securities, determine whether there is sole reliance upon conclusions of external rating services when evaluating the securities.
3. Determine that rigorous credit standards are applied regardless of the role the organization plays in the securitization process, e.g., servicer, credit enhancer, or investor.
4. Determine that major policies and procedures, including internal credit review and approval procedures and ''in-house'' exposure limits, are reviewed periodically and approved by the bank's board of directors.
5. Determine whether adequate procedures for evaluating the organization's internal control procedures and financial strength of the other institutions involved in the securitization process are in place.
6. Obtain the documentation outlining the remedies available to provide credit enhancement in the event of a default. Also, both originators and purchasers of securitized assets have prospectuses on the issue. Obtaining a copy of the prospectus can be an invaluable source of information. Prospectuses generally contain information on credit enhancement, default provisions, subordination agreements, etc. In addition to the prospectus, obtain the documentation confirming the purchase or sale of a security.
7. Ensure that, regardless of the role an institution plays in securitization, the documentation for an asset-backed security clearly specifies the limitations of the institution's legal responsibility to assume losses.
8. Verify whether the banking organization, acting as originator, packager or underwriter, has written policies addressing the repurchase of assets and other reimbursement to investors in the event that a defaulted package results in losses exceeding any contractual credit enhancement. The repurchase of defaulted assets or pools in contradiction of the underlying agreement in effect sets a standard by which a banking organization could potentially be found legally liable for all ''sold'' assets. Review and report any situations in which the organization has repurchased or otherwise reimbursed investors for poor quality assets.
9. Classify adverse credit risk associated with securitization of assets when analyzing the adequacy of an organization's capital or reserve levels. Evaluate credit risk of asset-backed securities and classify any adverse credit risk. List classified assets. Also, evaluate the impact of the classification on capital adequacy and overall soundness of the institution.
10. Aggregate securitization exposures with all loans, extensions of credit, debt and equity securities, legally binding financial guarantees and commitments, and any other investments involving the same obligor when determining compliance with internal credit exposure limits.
11. Review the bank's valuation methodology used for asset-backed securities to determine if it is appropriate.
12. Review securitized assets for industrial or geographic concentrations. Excessive exposures to an industry or region among the underlying assets should be noted in the review of the loan portfolio.

13. Ensure that, in addition to policies limiting direct credit exposure, an institution has developed exposure limits with respect to particular originators, credit enhancers, trustees, and servicers.
14. Review the policies of the banking organization engaged in underwriting with regard to situations in which it cannot sell underwritten asset-backed securities. Credit review, funding capabilities, and approval limits should allow the institution to purchase and hold unsold securities. All potential credit exposure should be within legal lending limits.
15. Ensure that internal systems and controls adequately track the performance and condition of internal exposures, and should monitor the organization's compliance with internal procedures and limits. In addition, adequate audit trails and internal audit coverage should be provided. Ensure that the reports have adequate scope and frequency of detail.
16. Determine that management information systems provide:
    a. A listing of all securitizations in which the organization is involved;
    b. A listing of industry and geographic concentration;
    c. Information on total exposure to specific originators, servicers, credit enhancers, trustees or underwriters;
    d. Information regarding portfolio aging and performance relative to expectations; and
    e. Periodic and timely information to senior management and directors on the organization's involvement in, and credit exposure arising from, securitization.
17. Ensure that internal auditors examine all facets of securitization regularly.
18. Review policies and procedures for compliance with applicable state lending limits and federal law such as section 5136 of the Revised Codes. These requirements must be analyzed to determine whether a particular asset-backed security issue is considered a single investment or a loan to each of the creditors underlying the pool. Collateralized mortgage obligations may be exempt from this limitation, if they are issued or guaranteed by an agency or instrumentality of the U.S. government.
19. Determine whether the underwriting of asset-backed securities of affiliates are:
    a. Rated by an unaffiliated, nationally recognized statistical rating organization; or
    b. Issued or guaranteed by FNMA, FHLMC, or GNMA, or represent interests in such obligations.
    c. Determine if purchases of high-risk mortgage-backed securities were made to reduce the overall interest rate risk of the bank. Determine if the bank evaluates and documents at least quarterly whether these securities have reduced the interest rate risk.
    d. Review and discuss any documentation exceptions, violations, internal control exceptions, and classifications with management, and obtain management's response.
    e. Review the bank's liquidity agreements with any asset-backed commercial paper programs and determine whether the agreements have any credit related components. Is the bank required to purchase the assets? Are these assets repurchased from the bank? If the facility is determined to be a commitment, determine whether its maturity is short-term or long-term. Do any of the liquidity agreements contain a material adverse clause or any other credit contingency provision?

Review the bank's internal controls, policies, practices and procedures for all aspects of asset securitization. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information.

POLICIES

1. Does the bank employ the services of a securities dealer? If so, does the bank rely solely on the advice of such dealer when purchasing asset-backed securities for the bank's investment portfolio? Does the bank have persons responsible for reviewing/approving the investment manager's acquisitions? Are there minimum established criteria for selecting a securities dealer?
2. Has the board of directors, consistent with its duties and responsibilities, reviewed and ratified asset securitization policies, practices, and procedures which:
   a. Require an initial thorough and independent credit assessment of each pool for which the bank has assumed credit risk as either a participant in the securitization process or as an investor?
   b. Address the repurchase of assets and other forms of reimbursement to investors by the bank, when acting as the originator, packager, or underwriter, in the event that a default results in losses exceeding any contractual credit enhancement?
   c. Assure that the credit, pricing, and servicing standards for securitized assets are equivalent to standards for assets that remain on the bank's books?
   d. Assure that the credit, pricing, and servicing standards and compliance with any provisions relating to government guarantees are reviewed periodically by the board of directors?
   e. Establish ''in-house'' diversification requirements with respect to aggregate outstanding exposures to a particular institution, industry, or geographic area?
   f. Hedge the institution's exposure to adverse price movements when engaged in underwriting or market-making activities?
3. Are securitization policies reviewed and reaffirmed at least annually to determine if they are compatible with changing market conditions?

INTERNAL CONTROL/ MANAGEMENT INFORMATION SYSTEMS

4. Do the internal systems and controls adequately track the performance and condition of internal exposures, and do the systems monitor the bank's compliance with internal procedures and limits? Are adequate audit trails and internal audit coverage provided?
5. Do the cost accounting systems provide a reliable determination of the profitability and volatility of asset securitization activities?
6. Are management information systems and reporting procedures adequate, in that they:
   a. Provide a listing of all securitizations for which the bank is either originator, servicer, credit enhancer, underwriter, or trustee?
   b. Provide a listing of industry and geographic concentrations?
   c. Provide information on total exposure to specific originators, servicers, credit enhancers, trustees, or underwriters?
   d. Provide information regarding portfolio aging and performance relative to expectations?
   e. Provide periodic and timely information to senior management and directors on the organization's involvement in, and credit exposure arising from, securitization?
   f. Provide credit ratings assigned by independent rating agencies to all asset-backed securities held by the bank?

INTRODUCTION

Bank management is responsible for controlling risk at a level deemed acceptable for the organization. An effective risk-management program begins with the identification of exposures that could disrupt the timely and accurate delivery of business services or result in unexpected financial claims on bank resources. Risk management also involves the implementation of cost-effective controls and the shifting, or assignment, of risk to other parties through insurance coverage or other options. Although risk-management procedures vary in design and sophistication from bank to bank, each institution's decision-making process should effectively encompass the identification, control, and assignment of risk.

Risk management entails balancing the bank's operating productivity and costs, customer service and satisfaction, and risk avoidance and insurance protection. The risk-assessment program should be conducted annually to establish whether potential service disruptions and estimated risk-related financial costs and losses can be contained at levels deemed acceptable to bank management and the board of directors.

A bank's risk-management program should balance protection against significant losses with efficient operations and customer-service needs. Reliance on extensive controls could increase business costs and impair productivity. On the other hand, exposures to unanticipated or accidental occurrences could cause the bank to fail.

While insurance protection against significant loss is essential, banks should avoid excessive coverage for small-dollar exposures, such as typical teller differences. Insurance can provide a bank with the resources to restore business operations and financial stability after an unanticipated event has occurred, but a bank's own risk-management controls can prevent and minimize the business interruptions that compromise service delivery.

TYPES OF RISKS

Business risks generally fall into three categories: (1) physical property damage, (2) product failure or unintended employee performance, and (3) loss of key personnel. Common property risks are fires or natural disasters such as storms and earthquakes, but acts of violence or terrorism can also be included in this category. Risk-management programs for property damage should consider not only the protection and replacement of the physical plant, but also the effects of business interruptions, loss of business assets, and reconstruction of records.

Insurance programs increasingly cover the consequences of the second category, product failure or employee performance. These risks include the injury or death of employees, customers, and the public; official misconduct; and individual and class action suits alleging mistreatment or the violation of laws or regulations. All aspects of a bank's operation are susceptible to liability risks. While property-loss levels can be estimated with relative confidence, jury awards for personal injury or product liability, and the related litigation costs, often defy reasonable expectations. In addition, it can be difficult to identify potential sources of liability exposure.

The third category, personnel risk, concerns those exposures associated with the loss of key personnel through death, disability, retirement, or resignation, as well as threats to all employees and third parties arising out of crimes such as armed robbery and extortion. The consequences of personnel loss are often more pronounced in small and medium-sized banks that do not have the financial resources to support a broad level of management.

Risk-Management Program

Recognition of business exposures is an essential aspect of risk management. A sound risk-management program requires the annual review of all existing business operations and a risk assessment of all proposed services. Identified risks should be analyzed to estimate their potential and probable levels of loss exposure. While the historical loss experience of the bank and other service providers may be helpful in quantifying loss exposure, technological and societal changes may result in exposure levels that differ from historical experience.

Expanding interactive use of the Internet is now raising questions about liability for information recorded by third parties on business web sites. The rapid deployment of PC-based home-banking services has introduced banking risks that were nonexistent just a short time ago. Not only is developing technology introducing new risks, but damage awards from legal action have grown substantially, making exposure estimates based solely on historical records unreliable at best. Nevertheless, exposure estimates should still consider loss experience based on historical bank records, as well as industry experience, as summarized in publications of the Security and Risk Management Division of the American Bankers Association and The Surety Association of America.

Management must decide the most appropriate method for treating a particular risk. Although many factors influence this decision, the purpose of risk management is to minimize the costs associated with the risks. In that context, cost is broadly defined to include—

- the direct and consequential cost of loss-prevention measures (controls) plus
- insurance premiums plus
- losses sustained, including the consequential effects and expenses to reduce such losses, minus
- recoveries from third parties and indemnities from insurers on account of such losses plus
- pertinent administrative costs.

Although exact dollar amounts can seldom be inserted into this formula, and management cannot quantify the effect of risk-management costs on customer service or relations, all of these factors are pertinent for determining methods for managing risk within director-approved risk guidelines.

Bank risks with a low probability of occurrence, but with potentially high or even catastrophic financial and customer-service consequences, such as loan fraud, should be eliminated whenever possible. These risks can be eliminated by discounting operations where appropriate or by transferring risk to other parties through the use of third-party service providers. When the risk cannot be shifted to other parties or otherwise mitigated, the bank must protect itself with appropriate levels of insurance.

Systems of internal control are an integral aspect of a bank's risk-management program. The primary opportunity to contain risk is through the implementation of cost-effective controls, policies, and procedures that provide for the prevention, detection, and correction of situations that expose the bank to financial loss or disruption of operations. The controls required by section 3 of the Bank Protection Act of 1968 (and the Board's Regulation P, 12 CFR 216, promulgated thereunder) directly relate to risk management. Emergency preparedness, contingency planning, and records management also serve significant roles in the risk-control function.

Internal controls can prevent and minimize business interruptions that compromise service delivery, yet controls can also impair customer service, operating productivity, and cost. An effective risk-management program requires bank management to decide which exposures will be tightly controlled. Certain loss exposures may be deemed reasonable because of a low probability of loss, minimal level of expected financial loss or service disruption, or low level of cost associated with the recovery of assets and restoration of services.

Bank management may decide to reduce insurance premiums and claims-processing costs by self-insuring for various types of losses and by setting higher deductible levels. These actions should be based on the results of the risk assessment and be consistent with the limits established by the board of directors.

When selecting insurance carriers, banks should consider the financial strength and claims-paying capacity of the insurance underwriter. This procedure is important for all significant policy coverage lines, particularly on collateral taken to protect an extension of credit. A substantial number of insurers are typically considered vulnerable by rating agencies. Many large commercial enterprises acquire insurance coverage from foreign companies, and the quality of insurance supervision by many foreign countries does not meet the standards expected in the United States. The move of some large U.S. insurers to less regulated Caribbean countries, the imposition of insurance payout caps in high-risk regions like Florida, and the creation of insurance subsidiaries with large environmental exposure but with capped equity resources, increase exposure on collateralized bank lending and require a diligent risk-management program in each bank.

FIDELITY BOND

Insurance coverage under a fidelity bond includes reimbursement for loss, not only from employee dishonesty, but also from robbery, burglary, theft, forgery, mysterious disappearance, and, in specified instances, damage to offices or fixtures of the insured. Coverage applies to all banking locations except automated teller machines, for which coverage must be specifically added.

It is standard procedure for insurance companies to write fidelity bonds on a "discovery" basis. Under this method, the insurance company is liable up to the full amount of the policy for losses covered by the terms of the bond and discovered while the bond is in force, regardless of the date on which the loss was actually sustained by the bank. This applies even though lower coverage amounts or more restrictive terms might have been in effect on the date the loss was sustained. Alternatively, fidelity bonds may be written on a "loss sustained" basis, meaning that the bonding company is liable only to the extent of the coverage that was in effect at the time the loss was actually sustained.

All fidelity bonds require that a loss be reported to the bonding company within a specified time after a reportable item comes to the attention of management. Occasionally, activities that should be reported to the bank's bonding company are not reported because of uncertainty as to what may constitute a reportable item. Failure to file a report may jeopardize coverage for that loss.

The most widely used form of fidelity bond is the financial institution bond, Standard Form No. 24 (formerly named the banker's blanket bond). This form was revised effective January 1, 1986, by the Surety Association of America, after discussions with the American Bankers Association. The financial institution bond limits the liability of the insurance company to a predetermined dollar amount. All claims paid by the insurance company during the term of the bond are applied against the aggregate limit, and when losses exceed the aggregate limit the bond is automatically canceled. Any misrepresentations, omissions, concealments, or incorrect statements of material fact in the application are grounds for recision of the fidelity bond by the insurance company. Standard Form No. 24 includes the clauses described below. (Most banks carry amounts of coverage for clauses D and E equal to clauses A, B, C, and F, while other banks may consider lower limits for clauses D and E due to their cost and exposure.)

Clause A: Fidelity

Clause A covers loss as a result of dishonest or fraudulent acts by the bank's officers and employees, attorneys retained by the bank, persons provided by an employment contractor, and nonemployee data processors while performing services for the insured. It is common for this insuring agreement to specifically define the type of acts covered. Form No. 24 defines fidelity losses as "losses resulting directly from dishonest or fraudulent acts committed by an employee acting alone or in collusion with others. Such dishonest or fraudulent acts must be committed by the employee with manifest intent (a) to cause the insured to sustain such loss, and (b) to obtain financial benefit for the employee or another person or entity."

If any of the loss results directly or indirectly from loans, that portion of the loss is not covered unless the employee was in collusion with one or more parties and received a financial benefit of at least $2,500. Financial benefit does not include any employee benefits earned in the normal course of employment, including salaries, commissions, fees, bonuses, promotions, awards, profit sharing, or pensions.

Clause B: Premises

This clause protects the bank against loss of property (as defined in the bond) through robbery, burglary, larceny, misplacement, theft, or mysterious and unexplained disappearance. The property must not have been in transit at the time of loss. Although damage to offices and equipment under specified conditions are covered under this clause, premises coverage should not be confused with standard fire or other types of property insurance.

Clause C: Transit

Clause C covers loss of property that is in transit. The property must be in the custody of (1) a natural person acting as a messenger for the insured, (2) a transportation company transporting the property in an armored motor vehicle, or (3) a transportation company transporting the property by means other than an armored motor vehicle. Under clause C, "property" is limited to records; certified securities; and negotiable instruments that are not payable to the bearer, are not endorsed, and have no restrictive endorsements.

Clause D: Forgery

Clause D covers loss resulting from forged or altered checks, drafts, acceptances, and other instruments, as specified (except evidences of debt), which are received by the bank either over-the-counter or through clearings. Items received as a transmission through an electronic funds transfer system are not covered. Form No. 24 defines forgery to mean the signing of the name of another person or organization with intent to deceive.

Clause E: Securities

This clause covers the bank for loss from forgery or alteration of securities, documents, or written instruments, except those covered under clause D. Actual physical possession of the securities by the bank or its representative is necessary for coverage to exist. Loss through payment, redemption, or guaranty of forged, altered, or counterfeited U.S. savings bonds is also covered.

Clause F: Counterfeit Currency

Clause F offers protection from loss resulting from acceptance of counterfeit money of the United States, Canada, or any other country in which the insured maintains a branch office.

Many banks also obtain an excess coverage policy to extend the basic protection provided under the blanket bond in areas where the dollar volume of assets or exposure is particularly high. Excess coverage usually is written in multiples of $1 million and either carries a deductible clause, equal to the amount of the blanket bond, or states that coverage will be provided for the full amount of the excess policy when loss exceeds a specified amount. The most common form of this coverage is the excess bank employee dishonesty blanket bond, Standard Form No. 28. Fidelity bond protection can also be extended by purchasing the following common optional riders:

- *Automated teller machine rider.* Loss involving automated teller machines that are not situated within banking offices permanently staffed with a bank teller.
- *Computer systems rider.* Loss from fraudulent entry of data or change of data elements or programs in any scheduled computer system, such as Fedwire, CHIPS, SWIFT, an automated clearinghouse association that is a member of the National Automated Clearing House Association (NACHA), shared or leased ATMs, or proprietary systems.
- *Extortion threats to persons and extortion threats to property riders.* Loss of property (cash, securities) surrendered away from a banking office as the result of a threat to do bodily harm to a director, trustee, employee, or relative, or of threats to do damage to banking premises or property. While a bank may purchase this coverage with a rider to its fidelity bond, many banks purchase it as a separate policy.

Fidelity bond coverage is appropriate for all banks because it insures against certain risks with the potential for significant loss. The examiner should determine that management has attempted to identify the risks that might result in a significant loss and that those risks are not retained. When the bank under examination is a member of a bank holding company, and the holding company has purchased one fidelity bond to cover all affiliated banks, the examiner should determine that the policy is sufficient to cover the exposures of the subsidiary bank being examined. Split-limit coverage may reduce protection to the lesser amount in the event of a collusionary loss involving employees of subsidiary banks and other affiliates of a bank holding company.

SPECIALIZED FORMS OF BANK INSURANCE

The banking industry requires specialized forms of insurance for which the blanket bond, along with the related policies, endorsements, and specific coverages previously noted, may provide insufficient protection. Banks also may need many of the same types of insurance, as described below, required by any business or individual.

The following is not intended to be a comprehensive list of the coverages available, but rather a listing of those that are most frequently purchased.

Combination Safe Depository

There are two types of combination safe depository coverage:

- *Coverage A.* This coverage applies to losses when the bank is legally obligated to pay for loss (including damage or destruction) of a customer's property held in safe deposit boxes.
- *Coverage B.* This insurance generally covers loss, damage, or destruction of property in customers' safe deposit boxes, whether or not the bank is legally liable, when the loss results from an activity other than employee dishonesty. This policy commonly provides for reimbursement of legal fees in conjunction with defending suits involving alleged loss of property from safe deposit boxes.

Directors' and Officers' Liability

This form of insurance protects, under two insuring clauses, against the expense of defending suits alleging director or officer misconduct and against damages that may be awarded. One clause, corporate reimbursement, reimburses the bank for any payments made to directors or officers under an indemnification agreement with them. The other clause reimburses the directors or officers for losses not covered by an indemnification agreement. Directors' and officers' liability policies do not cover libel or slander, proven dishonesty, or situations when the involved person obtained personal gain; therefore, they are not written in a standard form.

Fiduciary Insurance Coverage

Rather than individual policies, a master or comprehensive policy is often obtained to cover the properties held or managed by the trust department. This policy protects the trust account properties from fire or other loss, and insures the accounts and the bank against third-party liability in connection with the properties. The master policy does not cover claims by trust customers against the bank for negligence, errors, or violations resulting in loss to fiduciary accounts; however, fiduciary (or trust department) errors and omissions policies incorporate these areas.

Without a special endorsement, however, neither the fiduciary errors and omissions nor the bank's directors' and officers' liability insurance will cover liability arising under the Employee Retirement Income Security Act of 1974 (ERISA). For protection against exposure arising from a breach of fiduciary duty under ERISA, a special ERISA Errors and Omissions endorsement is required (also called fiduciary or employee benefit plan liability). In addition to bank trust departments, banks whose only fiduciary responsibilities relate to their employee benefit plan should consider this coverage. A related specialized available coverage is IRA/Keogh errors and omissions.

Fidelity bond coverage will usually protect the bank from liability for the loss or theft of property held in trust department accounts. The policy should be reviewed to determine the extent of coverage provided for other trust-related activities.

Mortgage Errors and Omissions

This coverage protects the bank, as mortgagee, from loss when fire or all-risk insurance on real property held as collateral inadvertently has not been obtained. Generally, this insurance is not intended to overcome errors in judgment, such as inadequate coverage or the insolvency of an original insurer.

Mortgage Impairment Insurance

This insurance covers the bank in three ways. First, it protects the bank from loss to its mortgagee interest in commercial or residential property (including mobile homes) when the bank, or those representing it, fail through error or omission to make sure that the property is adequately insured. Second, it protects the bank from loss to its mortgagee interest in property (which can also include mobile homes) that is damaged and either improperly insured or not insured, no matter what the reason. Third, it applies to trust properties where a mortgage is involved, and protects the bank from losses that are the result of its errors or omissions in putting insurance into effect for trust or other properties it holds in a fiduciary capacity.

Cash Letter Insurance

This form of insurance covers costs for reproducing cash letter items and items remaining uncollectible after a specified period of time. Generally, these policies do not cover losses due to dishonest acts of employees.

First Class, Certified, and Registered Mail Insurance

This coverage provides protection on shipment of property sent by various types of mail, and during transit by messenger or carrier to and from the post office. It is principally used to cover registered mail in excess of the maximum $25,000 insurance provided by the U.S. Postal Service.

Stockbrokers' Blanket Bond

This insurance covers loss resulting from the dishonesty of officers and employees, and burglary, robbery, larceny, misplacement, mysterious disappearance, damage, or destruction of money, securities, etc., on insured premises and in the custody of a designated messenger or armored car.

Aircraft Insurance

Although aviation liability exposures are frequently overlooked in the myriad of other financial institution exposures, they have tremendous potential for catastrophic loss and must be addressed by senior risk-management executives at all financial institutions. Exposures range from the more typical owned and nonowned liability and physical damage exposures to the more exotic hangarkeepers, aviation products, and airport/heliport premises exposures. In view of the specialized nature of aviation exposures, it is vitally important that the bank deal with knowledgeable and experienced agents/brokers and underwriters in developing an aviation insurance program.

While exposure categories overlap significantly, the following summary highlights the key areas of concern to most financial institutions.

Aviation Liability

In view of the potential for catastrophic aviation-related loss, the level of aviation liability insurance that a bank maintains should be commensurate with its exposure. The aviation liability program should be written to include aviation products liability, all owned/nonowned exposures, and passenger liability. A bank's umbrella liability insurance program should also apply over the aviation limit.

Nonowned Exposures

While many banks do not feel the need for aviation insurance because they do not own an aircraft, they may overlook nonowned aviation liability exposures and may, in fact, need this coverage. For example, an employee may use a personal aircraft on bank business or lease or rent an aircraft to ferry customers or employees to a distant meeting. It is also possible that a nonowned exposure could be created by financing or leasing an aircraft, even though the aircraft is not under bank control.

Most aviation underwriting markets have programs available to meet the above exposures. However, additional exposures may require special coverage. Banks should consider the following situations:

- If the bank does repair and maintenance work to the aircraft, it may incur a products liability exposure after control is relinquished to others, such as in a sale of the aircraft.
- If the bank finances aircraft, maintaining only a security interest, it becomes an owner when it repossesses the aircraft, and a definite need for both liability and physical damage coverage may arise. This coverage may be written at the time of repossession or negotiated in advance of need. The bank should not attempt to continue coverage for its exposure under the borrower's policy.

All-Risk Physical Damage

To protect the bank's security interest in an aircraft hull, borrowers should be required to maintain full-value, all-risk physical damage insurance (both ground-risk and in-flight coverage) in favor of the bank. However, a number of warranties in aircraft insurance policies could void the contract, so bankers are further advised to require that a borrower's hull insurance policy contain a breach-of-warranty endorsement to protect the bank in the event the borrower or owner violates provisions of the policy. The underwriter should agree to give the bank at least 30 days' advance notice of any change in the policy. Depending on the use of the aircraft, special consideration should be given to the territorial limits of coverage and confiscation protection. Since breach-of-warranty endorsements, like aircraft insurance policies, are far from standard, it is important that the bank understand and agree with the underwriter's language. In this economic environment, it is particularly appropriate to review the consequences of potential recovery to the lien holder in the event that the aircraft is damaged while a delinquency exists on the note.

Bank as Lessor

If the bank's security interest is that of the lessor, aviation liability insurance should be carried by the bank as lessor and also by the customer as lessee. In certain cases, it may be appropriate to require the lessee, through his underwriter, to provide the equivalent of the breach-of-warranty endorsement to the liability program as well as the physical damage. The bank may also consider contingent lessor's liability.

Airport Premises and Hangarkeepers

If the bank repossesses real estate on which an airport facility exists and continues to operate or the bank permits use of the facility pending further sale, the bank picks up airport premises and possibly control-tower liability exposures. Both the bank's comprehensive general liability and aviation liability programs should be reviewed for proper coverage.

If the bank owns or operates a hangar for its aircraft and attempts to share the burden of costs with others via the rental of space for an aircraft, it can pick up hangarkeeper's liability exposure, unless the contract is properly worded. Appropriate consideration should be given to hold-harmless indemnification clauses, insurance requirements, and waivers of subrogation.

Accidental Death and Dismemberment/Travel Accident

Other aspects of aviation exposures should be considered. Many accidental death and dismemberment and corporate business travel accident insurance programs exclude coverage in corporate-owned, -leased, or -hired aircraft. Banks need to review the language of these policies carefully to be certain that they provide desired coverages.

Automobile Insurance

This insurance protects against property and liability losses arising from injury or death when a bank-owned, -rented, or -repossessed vehicle is involved. Nonownership liability insurance should be considered if officers or employees use their own cars for bank business.

Specific extensions of coverage should, at a minimum, include—

- special repossessed-automobile liability and physical-damage protection,
- special protection for injuries by one employee to another employee, and
- special garage-proprietor's liability for institutions that rent their parking facilities to customers or the general public.

Property Damage

Several types of insurance coverage are available to help banks recover from property damage. Boiler and machinery insurance provides coverage for loss caused by an explosion or other forms of destruction of boilers, heating and/or cooling systems, and similar types of equipment.

Extra expense coverage provides funds for the additional costs of continuing the bank's operations at another location after fire or other catastrophe for an insured peril.

Business interruption insurance covers loss of earnings when business operations are interrupted because of damage or destruction of the insured's premises.

Fire Insurance

Fire insurance covers all losses directly attributed to fire, including damage from smoke or water and chemicals used to extinguish the fire. Additional fire damage for the building contents may be included, but often is written in combination with the policy on the building and permanent fixtures. Most fire insurance policies contain ‘‘co-insurance’’ clauses, meaning that insurance coverage must be maintained at a fixed proportion of the replacement value of the building. If a bank fails to maintain the required relationship of protection, all losses will be reimbursed at the ratio of the amount of the insurance carried to the amount required, applied to the value of the building at the time of the loss. When determining insurable value for fire insurance purposes, the base typically is the cost of replacing the property with a similar kind or quality at the time of loss. Different types of values, however, may be included in policies, and care should be taken to ensure that the bank is calculating the correct ‘‘value.’’

General Liability

This insurance covers the bank from possible losses arising from a variety of occurrences. Typically, general liability insurance provides coverage against specified hazards, such as personal injury, medical payments, landlords’ or garage owners’ liability, and other specific risks that may result in or create exposure to a suit for damages against the bank. Comprehensive general liability insurance covers all risks, except specific exclusions.

Workers’ Compensation

This policy covers liability imposed by the workers’ compensation laws of the state in which operations are performed. Workers’ compensation covers injuries or deaths of employees caused by accidents in the course of employment.

If deemed necessary, some banks may add the following coverages to their workers’ compensation insurance:

- Longshore and Harborworkers Act coverage should be added if the institution’s lending officers may have reason to visit customers on navigable waters.
- Foreign compensation protection should be added if workers are assigned abroad.

Insurance for Other Reasons

Key-Person Insurance

This coverage insures the bank on the life of an officer when the death of this officer, or key person, would be of such consequence as to give the bank an insurable interest.

Split-Dollar Life Insurance

Split-dollar life insurance is a type of life insurance in which the purchaser of the policy pays at least part of the insurance premiums and is entitled to only a portion of the cash surrender value, or death benefit, or both. Refer to SR-93-37 (‘‘Split-Dollar Life Insurance,’’ June 18, 1993) and its attachments for further discussion of the Federal Reserve’s position on these arrangements between bank holding companies and their subsidiary banks.

Umbrella Liability

This type of insurance provides excess coverage over existing liability policies, as well as basic coverage for most known risks not covered by existing insurance.

Valuable Papers and Destruction of Records Policy

This insurance covers the cost of reproducing damaged or destroyed records. It also provides for the cost of research required to reproduce records.

RECORDKEEPING

The diversity of available insurance policies and their coverages emphasize the need for banks to maintain a concise, easily referenced schedule of insurance coverage. These records should include—

- insurance coverage provided, detailing major exclusions;
- the underwriter;
- deductible amounts;
- upper limits on policies;
- terms of the policies;

- the dates that premiums are due; and
- premium amounts.

Banks should retain the original policies and supporting documents for the appropriate time periods. Records of losses should also be maintained, regardless of whether the bank was reimbursed. This information indicates areas where internal controls may need to be improved and is useful in measuring the level of risk exposure in a particular area.

COMPARATIVE DATA

To help the examiner assess the adequacy of a bank's insurance coverage, this subsection provides several tables compiled by the American Bankers Association. The tables show the different types of insurance, as well as the amount of coverage, carried by banks, which are grouped by asset size. However, a bank's level of risk exposure is influenced by many variables, one of which is asset size. Therefore, the examiner must assess the overall soundness of the bank's risk and insurance management program, rather than suggest an average coverage that may be inappropriate for the particular bank.

BANK INSURANCE: FINANCIAL INSTITUTION BOND AND OTHER INSURANCE COVERAGE

The following tables appeared in the ''1995 Bank Insurance Survey Report'' by the American Bankers Association and were compiled from information submitted by banks during 1994. The survey includes data from 293 banks using a probability sample of 2,000 banks of various asset sizes.

TABLE 1
DISTRIBUTION OF BANKS IN THE UNITED STATES AND INCLUDED IN THE SURVEY

	Asset size (in millions)					
	Less than $100	*$100–249*	*$250–999*	*$1,000–4,999*	*$5,000–19,999*	*$20,000 and more*
Number of banks in U.S.[1] (as of 12/31/94)	7,259	1,964	837	257	110	26
Number of banks included in this survey	82	63	71	43	23	11

1. From: FDIC, Report of Condition and Income.
SOURCE: American Bankers Association, ''1995 Bank Insurance Survey Report.''

TABLE 2
SUMMARY OF FINANCIAL INSTITUTION BOND COVERAGE[1]

	Coverage limits (in thousands)		
Asset size (in millions)	*Median coverage*	*Most frequent coverage*	*Aggregate coverage per $1 million total assets— minimum, median, and maximum*
$ 1–49	$ 1,250	$ 1,000	$22, 63, & 145
50–99	2,075	1,000	10, 30, & 81
100–249	2,800	2,800	7, 19, & 53
250–499	4,875	3,750 & 4,750 & 5,000[2]	4, 15, & 43
500–999	8,000	10,000	3, 11, & 26
1,000–2,499	20,000	20,000	5, 13, & 22
2,500–4,999	20,000	15,000	3, 7, & 21
5,000–9,999	50,000	50,000	2, 7, & 10
10,000–19,999	60,000	60,000 & 100,000[2]	2, 5, & 7
20,000 & over	100,000	100,000	1, 2, & 6

1. The Summary of Financial Institution Bond Coverage is not a recommended amount of coverage. It is a statistical summary by asset size for such coverage.
2. Tie between most frequent coverage.

SOURCE: American Bankers Association, "1995 Bank Insurance Survey Report."

TABLE 3
BANKS WITH INSURANCE COVERAGE

Type of coverage	Asset size (in millions) Less than $100	$100–249	$250–999	$1,000–4,999	$5,000–19,999	$20,000 and more
Excess insurance—duplicate of FIB						
Excess all clauses	5.1%	4.8%	1.4%	7.0%	13.0%	10.0%
Excess clause A (officer and employee fidelity)	8.9	15.9	5.6	2.3	4.3	–
Form 28 (excess bank employee dishonesty blanket bond)	25.3	28.6	5.6	–	–	–
Excess clause B (on premises)	1.3	1.6	–	2.3	4.3	–
Excess clause C (in transit)	–	1.6	–	2.3	4.3	10.0
Excess clause D (check forgery)	1.3	1.6	–	2.3	4.3	10.0
Excess clause E (securities forgery)	–	1.6	–	2.3	4.3	10.0
All-risk policies						
All-risk securities	2.5	–	–	4.7	4.3	40.0
All-risk premises	3.8	1.6	1.4	2.3	–	40.0
All-risk transit	1.3	–	–	4.7	4.3	40.0
Fill-in policies	3.8	1.6	1.4	–	13.0	30.0
Excess directors and officers	10.0	6.3	8.6	27.9	69.6	70.0
Trust department errors and omissions	16.3	19.0	54.3	60.5	78.3	20.0
Bankers' professional liability	8.8	11.1	5.7	32.6	30.4	60.0
Fiduciary liability	35.0	65.1	71.4	88.4	91.3	90.0

NOTE: "–" indicates not available.

TABLE 3—CONTINUED

Type of coverage	Asset size (in millions) Less than $100	$100–249	$250–999	$1,000–4,999	$5,000–19,999	$20,000 and more
Electronic data processing	65.0	74.6	78.6	90.7	87.0	80.0
Equipment	61.3	71.4	77.1	88.4	78.3	80.0
Media	47.5	61.9	70.0	88.4	78.3	80.0
Extra expense	53.8	65.1	72.9	88.4	78.3	80.0
Business interruption	32.5	41.3	34.3	53.5	52.2	60.0
General liability	86.3	88.9	97.1	97.7	100.0	100.0
Umbrella and excess liability	70.0	87.3	95.7	97.7	100.0	100.0
Kidnap/extortion[1]	26.3	42.9	51.4	81.4	100.0	100.0
Threats to persons	25.0	42.9	51.4	81.4	95.7	100.0
Threats to property	22.5	34.9	38.6	74.4	78.3	90.0
Buildings and contents	86.3	90.5	92.9	100.0	100.0	100.0
Worker's compensation	92.5	100.0	97.1	100.0	100.0	90.0
Insurance	67.5	77.8	72.9	93.0	95.7	90.0
State fund	16.3	25.4	30.0	11.6	17.4	40.0
Self-insurance	1.3	4.8	4.3	4.7	21.7	50.0
Electronics and computer crime[1]	3.8	9.5	11.4	11.6	39.1	30.0
Mail	15.0	39.7	65.7	86.0	100.0	100.0
Automobile	86.3	93.7	98.6	100.0	100.0	100.0
Physical damage	67.5	88.9	85.7	83.7	39.1	30.0
Actual cash value	58.8	74.6	78.6	81.4	39.1	30.0
Stated value	10.0	19.0	15.7	11.6	–	–
Liability	83.8	92.1	98.6	100.0	100.0	100.0
Leased vehicles contingent liability coverage	13.8	15.9	20.0	32.6	60.9	60.0
Mortgage insurance	45.0	81.0	91.4	90.7	100.0	90.0
Mortgage errors and omissions	41.3	79.4	82.9	76.7	87.0	90.0
Mortgage impairment	16.3	46.0	57.1	69.8	91.3	90.0
Other	35.0	44.4	50.0	74.4	73.9	50.0

NOTE: "–" indicates not available.

1. Separate policy, not included in Financial Institution Bond.

SOURCE: American Bankers Association, "1995 Bank Insurance Survey Report."

TABLE 4
AVERAGE POLICY LIMITS PER BANK

	Asset size (in millions)					
Type of coverage	*Less than $100*	*$100–249*	*$250–999*	*$1,000–4,999*	*$5,000–19,999*	*$20,000 and more*
Financial Institution Bond—per loss						
Clause A (officer and employee fidelity)	$ 1.4	$ 2.4	$ 4.9	$ 16.0	$ 35.2	$ 89.4
Clause D (check forgery)	0.7	1.6	3.8	15.5	36.7	89.4
Clause E (securities forgery)	0.7	1.6	3.6	15.9	37.4	89.4
Clause F (counterfeit currency)	1.0	2.0	4.7	16.2	34.5	89.4
Kidnap/extortion rider						
Threats to persons	0.6	1.2	2.5	3.5	8.3	–
Threats to property	0.6	1.1	2.3	4.4	8.8	–
Trading loss rider	1.0	1.9	4.0	17.3	35.0	68.3
Central handling of securities	–	1.9	4.8	21.0	35.4	72.0
ATM rider	0.1	0.5	0.8	3.4	8.9	30.1
Computer systems rider	1.1	1.9	3.9	15.5	29.3	72.0
Aggregate limit buyback	–	–	–	–	–	–
Safe deposit						
Legal liability	0.6	1.2	2.3	4.8	10.4	85.0
Customer property	0.5	1.0	2.1	4.5	10.6	117.5
Financial Institution Bond—aggregate						
Clause A (officer and employee fidelity)	2.3	3.2	7.5	24.1	52.1	102.2
Clause D (check forgery)	1.6	2.5	6.2	25.1	53.2	110.0
Clause E (securities forgery)	1.8	2.5	6.4	25.1	50.3	110.0
Clause F (counterfeit currency)	1.6	3.0	7.3	25.5	53.9	93.3
Kidnap/extortion rider						
Threats to persons	0.9	1.2	2.7	7.5	10.0	–
Threats to property	0.8	1.2	2.4	6.7	–	–
Trading loss rider	1.2	–	4.4	–	–	–
Central handling of securities	–	–	8.3	–	–	–
ATM rider	–	–	–	–	–	50.1
Computer systems rider	0.7	1.6	6.2	15.0	36.4	100.0
Aggregate limit buyback	2.4	–	–	–	–	–
Safe deposit						
Legal liability	0.8	1.2	2.6	7.4	50.0	100.0
Customer property	0.7	1.6	2.1	7.3	50.0	100.0

NOTE: "–" indicates not available.

TABLE 4—CONTINUED

	Asset size (in millions)					
Type of coverage	*Less than $100*	*$100–249*	*$250–999*	*$1,000–4,999*	*$5,000–19,999*	*$20,000 and more*
Excess insurance						
Excess all clauses	0.8	1.0	1.0	7.5	–	–
Excess clause A (officer and employee fidelity)	0.8	1.0	1.0	–	–	–
Form 28 (excess bank employee dishonesty blanket bond)	1.0	1.0	1.0	–	–	–
Excess clause B (on premises)	0.3	1.0	1.0	5.0	20.0	–
Excess clause C (in transit)	–	1.0	1.0	5.0	20.0	–
Excess clause D (check forgery)	0.3	1.0	1.0	5.0	20.0	–
Excess clause E (securities forgery)	–	1.0	1.0	5.0	20.0	–
All-risk policies						
All-risk securities	–	–	–	42.5	100.0	326.3
All-risk premises	0.3	0.3	10.0	10.0	30.0	335.0
All-risk transit	–	–	–	–	–	335.0
Directors' and officers' liability						
Each director/officer	1.3	2.3	5.6	10.5	19.5	46.9
Aggregate directors/officers	1.5	2.3	5.2	10.5	19.2	47.8
Corporate reimbursement	2.1	2.4	5.8	10.4	19.0	44.0
Excess directors and officers	1.0	1.0	4.5	10.0	17.1	43.6
Trust department errors and omissions	1.1	1.4	2.3	5.3	14.4	–
Average trust assets per bank	18	130	136	442	3,354	–
Bankers' professional liability	1.4	1.2	1.0	6.6	14.2	24.2
Fiduciary liability (ERISA)	1.0	1.8	1.9	4.6	10.2	41.1
Safe-deposit liability coverage[1]						
Coverage A (legal liability)	0.6	0.8	2.4	4.1	13.0	19.2
Coverage B (customers)	0.8	0.9	1.9	2.8	5.4	26.7
Electronic data processing						
Equipment	0.2	0.5	1.5	5.2	47.1	40.0
Media	0.1	0.1	0.4	0.5	7.9	2.8
Extra expense	0.1	0.1	0.6	1.2	9.3	23.0
Business interruption	0.1	0.1	0.6	3.9	14.3	–
General liability	1.5	1.7	1.8	1.8	2.3	1.5
Umbrella and excess liability	2.5	4.5	9.1	20.1	44.1	119.0

NOTE;"–"indicates not available.

TABLE 4—CONTINUED

Type of coverage	*Asset size (in millions)* Less than $100	$100–249	$250–999	$1,000–4,999	$5,000–19,999	$20,000 and more
Kidnap/extortion[1]						
Threats to persons	0.9	1.6	3.1	6.5	11.6	28.6
Threats to property	0.8	1.5	3.2	6.6	12.2	30.8
Buildings and contents	1.7	4.0	14.1	55.7	235.1	775.0
Electronics and computer crime[1]	–	1.3	5.6	20.0	37.8	46.7
Automobile						
Physical damage	–	–	–	–	–	–
Liability	0.8	0.9	0.9	1.0	1.0	1.2
Number of owned vehicles	2	5	10	36	77	318
Leased vehicles contingent liability coverage	0.8	0.9	0.8	1.6	1.7	1.8
Mortgage insurance						
Mortgage errors and omissions	0.6	0.9	1.4	3.3	6.1	16.8
Mortgage impairment	0.8	0.9	1.7	3.6	5.4	19.3

NOTE: "–" indicates not available.

1. Separate policy, not included in Financial Institution Bond.

SOURCE: American Bankers Association, "1995 Bank Insurance Survey Report."

TABLE 5
SELECTED CLAUSES AND RIDERS MAINTAINED UNDER THE FINANCIAL INSTITUTION BOND

	Asset size (in millions)					
Type of clauses/riders[1]	*Less than $100*	*$100–249*	*$250–999*	*$1,000–4,999*	*$5,000–19,999*	*$20,000 and more*
Clause D (check forgery)	97.5%	100.0%	95.8%	100.0%	100.0%	100.0%
Clause E (securities forgery)	96.2	100.0	97.2	100.0	100.0	100.0
Clause F (counterfeit currency)	73.4	79.4	80.3	90.7	91.3	100.0
Kidnap/extortion rider						
Threats to persons	83.5	65.1	53.5	23.3	17.4	20.0
Threats to property	68.4	60.3	43.7	20.9	17.4	20.0
Trading loss rider	32.9	55.6	54.9	88.4	95.7	90.0
Central handling of securities	7.6	15.9	29.6	72.1	78.3	80.0
Automated teller machines (unattended ATMs)	39.2	55.6	70.4	76.7	78.3	60.0
Computer systems rider, other EFT rider, or separate rider for computer systems	78.5	92.1	76.1	81.4	73.9	90.0
Aggregate limit buyback	12.7	9.5	5.6	9.3	17.4	10.0
Safe-deposit legal liability	79.7	66.7	66.2	79.1	56.5	80.0
Customer property	38.0	36.5	40.8	53.5	34.8	50.0

1. Clause A (officer and employee fidelity), Clause B (on premises), misplacement (under Clause B), and Clause C (in transit) are part of the basic bond quotation. These clauses are maintained by all banks carrying Financial Institution Bonds.

SOURCE: American Bankers Association, “1995 Bank Insurance Survey Report.”

TABLE 6
TYPE OF ELECTRONIC AND COMPUTER CRIME COVERAGE MAINTAINED UNDER THE FINANCIAL INSTITUTION BOND OR OTHER POLICY/RIDER

	Asset size (in millions)					
Type of crime coverage	*Less than $100*	*$100–249*	*$250–999*	*$1,000–4,999*	*$5,000–19,999*	*$20,000 and more*
Electronic funds transfer	43.9%	73.0%	78.9%	90.7%	100.0%	90.9%
Bank proprietary systems	25.6	42.9	63.4	69.8	95.7	90.9
Software programmers, consultants	28.0	27.0	36.6	58.1	82.6	81.8
ATM systems	24.4	46.0	60.6	74.4	69.6	81.8
Telephone voice instructions	9.8	27.0	38.0	74.4	95.7	90.9
Telephone-toll fraud	1.2	6.3	16.9	25.6	30.4	36.4
Computer virus	3.7	7.9	26.8	55.8	87.0	63.6
Software piracy	2.4	6.3	11.3	37.2	26.1	27.3
Computer extortion	13.4	22.2	31.0	51.2	65.2	54.5
Facsimile transmissions	6.1	15.9	29.6	62.8	91.3	90.9

SOURCE: American Bankers Association, ''1995 Bank Insurance Survey Report.''

1. To determine if risk-management policies and procedures adequately identify, control, and treat risks.
2. To determine if the board of directors has established reasonable guidelines for the retention of risk.
3. To determine if insurance coverage adequately protects against significant or catastrophic loss.
4. To determine if recordkeeping practices are sufficient to enable effective risk and insurance management.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the Risk and Insurance Management section of the Internal Control Questionnaire.
2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal Control," and determine if appropriate corrections have been made.
3. Determine if the bank has a designated risk manager who is responsible for loss control. If not, determine which officer handles the risk and insurance management function.
4. Determine if written policies exist. If not, discuss informal policies with the appropriate officers to determine:
   a. Procedures used to identify and analyze risks.
   b. Methods used to control and treat risks.
5. Determine if the board of directors has established appropriate maximum guidelines for risk retention.
6. Obtain the bank's schedule of insurance policies in force. If the bank does not maintain a schedule, request the bank to complete a schedule of existing insurance coverage.
7. Using the insurance coverage summary prepared by the bank, determine that coverage conforms to the guidelines for maximum loss exposure established by the board of directors.
8. Determine whether insurance coverage provides adequate protection for the bank. The quality of internal controls and the audit function must be considered when making this assessment. The statistical summary published by the American Bankers Association (see Appendix) may be helpful in your evaluation.
9. If the bank's fidelity insurance has lapsed, determine that the Federal Reserve Bank has been notified.
10. Determine that the bank has adequate procedures to ensure that:
    a. Reports of losses are filed with the bonding company pursuant to policy provisions.
    b. Premiums are paid before expiration dates.

    If procedures are deficient in either area, verify that reports have been filed as required and premiums have been paid.
11. Review any significant financial institution bond claims filed since the last examination to determine:
    a. Any adverse effect on the bank's condition.
    b. Whether the incident(s) reflects any deficiencies with respect to internal controls and procedures.
    c. Whether management has taken appropriate steps to correct any deficiencies.
12. Prepare, in appropriate report form, and discuss with appropriate officers:
    a. Recommended corrective action when policies, practices, procedures, or internal controls are deficient.
    b. Important areas where insurance coverage is either nonexistent or inadequate in view of current circumstances.
    c. Any other deficiencies noted.
13. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for the bank's own insurance coverage. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative description, flow charts, copies of forms used, and other pertinent information.

BANK RISK AND INSURANCE MANAGEMENT

1. Does the bank have established insurance guidelines which provide for:
   a. A reasonably frequent, at least annual, determination of risks the bank should assume or transfer?
   b. Periodic appraisals of major fixed assets to be insured?
   c. A credit or financial analysis of the insurance companies who have issued policies to the bank?
2. Does the bank have a risk manager who is responsible for risk control?
3. Does the bank use the services of a professionally knowledgeable insurance agent, broker, direct writer, or consultant to assist in selecting and providing advice on alternative means of providing insurance coverage?
4. Does the bank's security officer coordinate his or her activities with the person responsible for handling the risk-management function?
5. Does the bank maintain a concise, easily referenced schedule of existing insurance coverage?
6. Does the bank maintain records, by type of risk, to facilitate an analysis of the bank's experience in costs, claims, losses, and settlements under the various insurance policies in force?
7. Is a complete schedule of insurance coverage presented to the board of directors, at least annually, for review and approval?

CONCLUSION

8. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
9. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

The examination of bank-related organizations must be of sufficient scope to determine a bank's compliance with laws and to evaluate its investments through appraisal of related organizations' assets, earnings, and management. In addition, the examination must fully disclose the nature of the relationships between the bank and its related organizations, and their effects on the operations and safety and soundness of the bank.

TYPES OF BANK-RELATED ORGANIZATIONS

Various laws, rulings, and regulations have encouraged the expansion of bank services through the formation or acquisition of related organizations. Examples include—

- permission for a member bank to purchase for its own account shares of a corporation that performs, at locations at which the bank is authorized to engage in business, functions that the bank is empowered to perform directly;
- authorization by specific laws to invest in various statutory subsidiaries; and
- permission by Federal Reserve regulations to invest in Edge Act and agreement corporations.

A bank may also be controlled by an individual or company that controls other bank or nonbank entities. No matter what the legal organization is between a bank and a related organization, a sound financial and satisfactory management relationship between both groups is essential to the bank's operation. Related organizations may assume several forms, as described in the following subsections.

Affiliates

Relative to the monitoring of covered transactions between a bank and its affiliates, as defined under subsection (b)(1) of section 23A of the Federal Reserve Act (12 USC 371c), affiliates include—

- any company that *controls* the member bank and any other company that is controlled by the company that controls the member bank;
- a bank subsidiary of the member bank;
- any company—
  - — that is controlled directly or indirectly, by a trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the member bank or any company that controls the member bank; or
  - — in which a majority of its directors or trustees constitute a majority of the persons holding any such office with the member bank or any company that controls the member bank;
- any company, including a real estate investment trust, that is sponsored and advised on a contractual basis by the member bank or any subsidiary or affiliate of the member bank; or any investment company with respect to which a member bank or any affiliate thereof is an investment advisor as defined in section 2(a)(20) of the Investment Company Act of 1940; and
- any company that the Board determines by regulation or order to have a relationship with the member bank or any subsidiary or affiliate of the member bank, such that covered transactions by the member bank or its subsidiary with that company may be affected by the relationship, to the detriment of the member bank or its subsidiary.

In these examples, the definition of "control" is the same as that used in the Bank Holding Company Act; that is, a company or shareholder shall be deemed to have control over another company if—

- such company or shareholder, directly or indirectly, or acting through one or more other persons, owns, controls, or has power to vote 25 percent or more of any class of voting securities of the other company;
- such company or shareholder controls in any manner the election of a *majority* of the directors or trustees of the other company; or
- the Board determines, after notice and opportunity for hearing, that such company or shareholder, directly or indirectly, exercises a controlling influence over the management or policies of the other company.

The following are *not* considered to be affiliates of a bank:

- a nonbank subsidiary of that bank
- a company engaged in holding that bank's premises
- a company engaged solely in conducting a safe deposit business
- a company engaged solely in holding U.S. government obligations or obligations fully guaranteed by the United States as to principal and interest
- a company where control arises from bona fide debt previously contracted (for a limited period of time)

Section 23A is the primary statute governing transactions with affiliates. The statute (1) designates the types of companies that are affiliates of a bank; (2) specifies the types of transactions covered by the statute; (3) sets the quantitative limitations on a bank's covered transactions with any single affiliate, and with all affiliates combined; and (4) sets forth collateral requirements for certain bank transactions with affiliates.

In general, section 23A limits covered transactions between a state member bank and its subsidiaries with any one affiliate to 10 percent of the bank's capital stock and surplus. Surplus includes undivided profits (which may include paid-in or earned profits), reserves for loan losses, valuation reserves for securities, and reserves for contingencies. The aggregate of all covered transactions with affiliates may not exceed 20 percent of the bank's capital and surplus. The act defines five types of covered transactions:

- a loan or extension of credit to an affiliate
- a purchase of or an investment in securities issued by an affiliate
- the purchase of assets, including assets subject to an agreement to repurchase from the affiliate, except for purchases of real and personal property as may be specifically exempted by the Board by order or regulation
- the acceptance of securities issued by an affiliate as collateral for a loan to any person or company (prohibited if a loan is to an affiliate)
- the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate

In addition, covered transactions must be made on terms and conditions that are consistent with safe and sound banking practices. Purchase of low-quality assets from an affiliate is prohibited by the statute.

Section 23B of the Federal Reserve Act was enacted on August 10, 1987, as part of the Competitive Equality Banking Act of 1987. This section places restrictions on the following transactions with affiliates:

- any covered transaction with an affiliate
- the sale of securities or other assets to an affiliate, including assets subject to repurchase
- the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise
- any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person
- any transaction or series of transactions with a third party—
  - — if an affiliate has a financial interest in the third party or
  - — if an affiliate is a participant in this transaction or series of transactions

A member bank and its subsidiaries may engage in the transactions covered by section 23B of the Federal Reserve Act, only on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank or its subsidiary, as its transactions with, or involving, nonaffiliates. Any transaction by a member bank or its subsidiary with any person is deemed to be a transaction with an affiliate of the bank if any of the proceeds of the transaction are used for the benefit of, or are transferred to, the affiliate.

Section 23B restricts the following transactions with affiliates:

- A member bank or its subsidiary cannot purchase as fiduciary any securities or other assets from any affiliate unless the purchase is permitted—
  - — under the terms of the instrument creating the fiduciary relationship,
  - — by court order, or
  - — by the laws governing the fiduciary relationship.
- A member bank or its subsidiary, whether acting as principal or fiduciary, cannot knowingly purchase or acquire, during the existence of any underwriting or selling syndicate, any security, if a principal underwriter of that security is an affiliate of the bank, unless the purchase has been approved before the

sale to the public by a majority of the outside directors.

Operations Subsidiaries and Loan Production Offices

A member bank may purchase for its own account shares of a corporation to perform, at locations at which the bank is authorized to engage in business, functions that the bank is empowered to perform directly. Moreover, a member bank may establish and operate, either directly or indirectly through a wholly owned subsidiary corporation, at any location in the United States, a loan production office. A loan production office is defined as an office of the bank that is staffed by employees of the bank who regularly engage in soliciting borrowers, negotiating terms, and processing applications for loans. However, actual loan approvals and funds disbursement may not occur at a loan production office.

There is no specific rule requiring a state member bank to give the Board prior notice of, or to acquire the Board's approval for, the acquisition of an operations subsidiary to engage in activities that the bank itself may lawfully perform. However, section 208.7(a)(1) of Regulation H prohibits a state member bank from causing or permitting a change in the general character of its business or the scope of its corporate powers approved at the time of admission to membership, except with the permission of the Board.

Agricultural Credit Corporations

The increasing number of agricultural credit corporations and their effect on parent banks have intensified the need for their supervision. Most agricultural credit corporations come under the direct supervision of the district Federal Intermediate Credit Bank (FICB) where they discount most of their loans. However, a corporation may obtain funds exclusively in the open market and avoid FICB regulation.

Edge Act and Agreement Corporations

U.S.-based corporations and permissible activities for their Edge Act and agreement corporation subsidiaries are described in detail in the Board's Regulation K (12 CFR, Part 211). Edge Act and agreement corporations provide banks with a vehicle for engaging in international banking or foreign financial operations. They also have the power, with supervisory consent, to purchase and hold the stock of foreign banks and other international financial concerns. Edge Act and agreement corporations are examined by the Federal Reserve, and the respective reports of examination should be reviewed during each examination of a parent member bank. The Federal Reserve examination report and the amount and quality of paper held by these corporations must provide the basis for evaluating the bank's investment in them.

Transactions between the parent bank and the bank's Edge Act and agreement corporation subsidiaries are not subject to the limitations contained in section 23A. However, they are subject to limitation under section 25 of the Federal Reserve Act (12 USC 601) and under the Board's Regulation K. In addition, transactions with such bank subsidiaries and the parent bank's affiliates are aggregated with transactions by the bank and its affiliates for purposes of section 23A limitations and restrictions. Transactions between a bank and Edge Act and agreement corporation subsidiaries of the bank's holding company are also subject to section 23A.

Domestic and Foreign Subsidiaries

Domestic subsidiaries are any majority-owned companies, other than Edge Act or agreement corporations, domiciled in the United States and its territories and possessions. Foreign subsidiaries are any majority-owned companies domiciled in a foreign country or any Edge Act or agreement corporation. Section 211.7 of Regulation K (12 CFR 211.7) requires foreign subsidiaries to maintain effective systems of records, controls, and reports that keep the bank's management informed of their activities and conditions.

On-site examinations of foreign subsidiaries are sometimes precluded because of objections voiced by foreign directors, minority shareholders, or local bank supervisors. In addition, secrecy laws in countries such as Switzerland, Singapore, Luxembourg, and the Bahamas preclude on-site examinations. In instances where on-site examinations cannot be performed, foreign subsidiary reports submitted according to section 211.7 and reports submitted to foreign banking authorities must serve as the basis for evaluating the bank's investment.

Significant Subsidiaries

As used in the consolidation instructions for certain regulatory reports, significant subsidiaries refer to subsidiaries that meet any one of the following tests:

- a majority-owned subsidiary in which the bank's direct and indirect investment and advances represent 5 percent or more of the parent bank's equity capital accounts
- a majority-owned subsidiary whose gross operating revenues amount to 5 percent or more of the parent bank's gross operating revenues
- a majority-owned subsidiary whose ''income (loss) before income taxes and securities gains or losses'' amounts to 5 percent or more of the parent bank's ''income (loss) before income taxes and securities gains or losses''
- a majority-owned subsidiary that is the parent of one or more subsidiaries which, when consolidated, constitutes a ''significant subsidiary'' as defined above

Associated Companies

Associated companies are those in which the bank directly or indirectly owns 20 to 50 percent of the outstanding common stock, unless the bank can rebut, to the Federal Reserve, the presumption of exercising significant influence. However, as noted above, for purposes of section 23A, affiliation is defined by 25 percent share ownership. Because of the absence of direct or indirect control, regulators have no legal authority to conduct full examinations of this type of company. Investments in such companies are generally appraised like commercial loans by a credit analysis of the underlying financial information.

Chain Banking Systems

Chain banking systems exist when an individual (or group of individuals) is a principal in two or more banking institutions, either banks or bank holding companies or a combination of both types of institutions. In these systems, the possibility exists that problems in one or more entities may adversely affect the safety and soundness of the bank entities because of pressure exerted by the common principal(s). Examiners should determine whether the bank is a member of a chain and, if so, the extent of its relationship with other links of the chain, and what effects these relationships have on the bank.

Real Estate Investment Trusts and Other Related Organizations

Other related organizations include companies in which the bank, its parent holding company, or its nonbank affiliate do not necessarily have any direct investment, but which the bank would sponsor or advise, or whose activities it would influence. The most notable examples are real estate investment trusts (REITs) or special-purpose vehicles. Transactions between the bank and REITs and investment companies sponsored or advised by the bank are subject to the limitations in section 23A. In other cases, because of nonownership or less than majority ownership, legal authority to conduct an examination does not exist.

A REIT may be considered an affiliate if it is sponsored and advised on a contractual basis by the member bank or by any subsidiary or affiliate of the member bank. In these cases, transactions between the bank and an affiliated REIT are subject to the requirements of section 23A. Because a REIT frequently carries a name that closely identifies it with its sponsoring bank or bank holding company, failure of the REIT could have an adverse impact on public confidence in the holding company and its subsidiaries.

The examiner should be aware of all significant transactions between the bank under examination and its related REIT in order to determine conflicts of interest and contingent risks. In several instances, REITs have encountered serious financial problems and have attempted to avoid failure by selling or swapping questionable assets to their bank affiliates. In other instances, because of the adversary relationship, REITs have been encouraged to purchase assets of inferior quality from their related organizations.

Bank Holding Companies

As defined in section 2 of the Bank Holding Company Act of 1956 (12 USC 1841 et seq.), a bank holding company is any company that directly or indirectly, or acting through one or more other persons, owns, controls, or has power to vote 25 percent or more of any class of voting securities of the bank or company; that controls in any manner the election of a majority of the directors or trustees of the bank or company; or that the Board determines, after notice and opportunity for hearing, directly or indirectly exercises controlling influence over the management or policies of the bank or company.

A bank and its parent holding company are considered affiliates when the holding company controls the bank in a manner consistent with the definition of control given in section 23A. Section 23A exempts from the quantitative and collateral requirements of the law all transactions (except for the purchase of low-quality assets) between ‘‘sister’’ banks (banks with 80 percent or more common ownership) in a bank holding company system. A low-quality asset is any asset (1) classified ‘‘substandard,’’ ‘‘doubtful,’’ ‘‘loss,’’ or treated as ‘‘other loans especially mentioned’’ in the most recent federal or state examination report; (2) on nonaccrual status; (3) with principal or interest payments more than 30 days past due; or (4) whose terms have been renegotiated or compromised due to the deteriorated financial condition of the borrower.

Under the Bank Holding Company Act of 1956 the Federal Reserve has authority to examine bank holding companies and their non-bank subsidiaries. The Federal Reserve requires periodic inspections of all bank holding companies, the frequency of which is based on the size, complexity, and condition of the organization. Often a bank holding company is inspected at the same time as the examination of its state member bank subsidiaries. In these cases, the examiner at the bank should collaborate closely with inspection personnel on those holding company issues that directly affect the condition of the bank. In cases where the inspection is not simultaneous with the examination, the bank examiner should closely review the most recent report of inspection and may also need to consult the Y-series of reports regularly submitted to the Federal Reserve System by bank holding companies.

EVALUATION OF INVESTMENTS IN AND LOANS TO BANK-RELATED ORGANIZATIONS

To properly evaluate affiliates and other bank-related organizations[1] relative to the overall condition of the bank, the examiner must—

- know the applicable laws and regulations that define and establish limitations with respect to investments in and extensions of credit to affiliates and
- make a thorough analysis of the propriety of the related organizations’ carrying value, the nature of the relationships between the bank and its related organizations, and the effect of such relationships on the affairs and soundness of the bank.

Propriety of the carrying value of a bank’s investment in any related organization is determined by evaluating the balance sheet and income statement of the company in which the bank has the investment. At times, this may not seem important in relation to the overall condition of the bank because the amount invested may be small relative to the bank’s capital. It may appear that a cursory appraisal of the company’s assets would therefore be sufficient. However, the opposite is often true. Even though a bank’s investment in a subsidiary or associated company is relatively small, the underlying legal or moral obligation may be substantial and may greatly exceed the total amount of the reported investment. If the subsidiary experiences large losses, the bank may have to recapitalize the subsidiary by injecting much more than its original investment to protect unaffiliated creditors of the subsidiary and/or to protect its own reputation.

When examining and evaluating the bank’s investment in and loans to related organizations, classified assets held by such companies should first be related to the capital structure of the company, and then be used as a basis for

1. Information about related organizations and interlocking directorates and officers can be obtained from the bank holding company form FR Y-6 and SEC form 10-K, if applicable, or from other required domestic and foreign regulatory reports. Further information on business interests of directors and principal officers of the bank can be obtained by reviewing information maintained by the bank in accordance with the Board’s Regulation O.

classifying the bank's investment in and loans to that company.

One problem that examiners may encounter when they attempt to evaluate the assets of some subsidiaries and associated companies is inadequate on-premises information. This may be especially true of foreign investments and associated companies in which the bank has less than a majority interest. In those instances, the examiner should request that adequate information be obtained during the examination and should establish agreed-on standards for that information in the future. The examiner should insist that the organization have adequate supporting information readily obtainable or available in the bank and that the information be of sufficient quality to allow an informed evaluation of the investment. Bank management, as well as regulatory authorities, must be adequately informed of the condition of the companies in which the bank has an investment. For subsidiary companies, it is necessary that bank representatives be a party to policy decisions, have some on-premises control of the company (such as board representation), and have audit authority. In the case of an associated company, the bank should participate in company affairs to the extent practicable. Information documenting the nature, direction, and current financial status of all such companies should be maintained at the bank's head office, or regionally for global companies. Full audits by reputable certified public accountants are often used to provide much of this information.

For foreign subsidiaries, in addition to audited financial information prepared for management, the bank should have on file:

- reports prepared according to the Board's Regulation K
- reports prepared for foreign regulatory authorities
- information on the country's cultural and legal influence on banking activities, current economic conditions, anticipated relaxation or strengthening of capital or exchange controls, fiscal policy, political goals, and risk of expropriation

For agricultural credit corporations, the examiner-in-charge normally decides when to examine such an entity and should always perform a complete analysis of its activities if—

- The corporation is not supervised by the FICB.
- The most recent FICB examination occurred over a year ago.
- The most recent FICB examination indicates that the corporation is in less than satisfactory condition.

The extent of any analysis should be based on the examiner's assessment of the corporation's effect on the parent bank. That analysis should include, but not be limited to, a review of—

- asset quality;
- the volatility, maturity, and interest-rate sensitivity of the asset and liability structures; and
- the bank's liability for guarantees issued on behalf of the corporation.

When the same borrower is receiving funds from both the corporation and the parent bank, and the combined exposure exceeds 25 percent of total consolidated capital, the debt should be detailed on the concentration page of the examination report. The consolidation procedures listed in the "Instructions for the Preparation of Consolidated Reports of Condition and Income" should be used when consolidating the figures of the corporation with those of its parent.

BANK HOLDING COMPANY ISSUES

Many banks are owned by bank holding companies. To understand the effects of the holding company structure on the subsidiary bank, the examiner should evaluate the overall financial support provided by the parent company, quality of supervision and centralized functions provided, and appropriateness of intercompany transactions. Since financial and managerial issues at the bank holding company and subsidiary bank levels are so closely connected, it is strongly recommended that a holding company inspection and its respective bank examination(s) be conducted at the same time. A combined examination/inspection report, as discussed in SR-94-46, is available to facilitate this coordination when the lead subsidiary is a state member bank.

Financial Support

The holding company structure can provide its subsidiary bank with strong financial support because of its greater ability to attract and shift funds to less capital-intensive areas and to enter markets in a wider geographic area than would otherwise be possible. Financial support may take the form of capital (equity or debt) and/or funding of loans and investments. In general, the lower the parent bank holding company's leverage, the more it is able to serve as a source of financial strength to its bank subsidiaries. This is because less cash flow will be required from the banks for debt servicing, and the parent has more borrowing capacity, which could be used to provide funds to the bank. When the financial condition of the holding company or its nonbanking subsidiaries is unsound, the operations of its subsidiary bank can be adversely affected. In order to service its debt, or to provide support to another subsidiary that is experiencing financial difficulty, the holding company may involve its bank subsidiary in the following imprudent actions:

- engage in high-risk investments to obtain increased yields
- purchase/swap its high-quality assets for the parent's or other affiliate's lower quality assets
- enter into intercompany transactions that are detrimental because of inordinately high fees or inadequate or unnecessary services
- pay excessive dividends
- make improper tax payments or unfavorably alter its tax situation

Even when the holding company's structure is financially sound, the holding company's ability to sell short- or long-term debt and to pass the proceeds down to its bank subsidiary in the form of equity capital still may present problems. That procedure is frequently referred to as "double leveraging," the amount of the equity investment in the bank subsidiary financed by debt. Problems may arise when the holding company must service its debt out of dividends from the subsidiary, and, if the subsidiary encounters an earnings problem or is prevented by regulatory agreement or action, it may not be able to pass dividends up to its parent.

Another potential problem may develop when the holding company sells its commercial paper and funds its subsidiary's loans with the proceeds. That procedure may cause a liquidity problem if the maturities of the commercial paper sold and loans funded are not matched appropriately and if the volume of such funding is large in relation to the subsidiary's overall operations.

On April 24, 1987, the Federal Reserve adopted a policy statement on the responsibility of bank holding companies to act as sources of financial and managerial strength to their subsidiary banks. The Board's statement reiterates a general policy that has been expressed on numerous occasions in accordance with authority that is provided under the Bank Holding Company Act and the enforcement provisions of the Federal Deposit Insurance Act.

BHC Supervision of Subsidiaries

Bank holding companies use a variety of methods to supervise their bank subsidiaries, including—

- the participation of holding company senior officers as directors on the bank's board;
- reporting lines from senior bank management to corporate staff;
- formulation of, or input into, key policies; and
- management information systems, including internal audit and loan review.

As part of the evaluation of bank management, the examiner should be aware of these various control mechanisms and determine whether they are beneficial to the bank. Examiners should keep in mind that, even in a bank holding company organization, the directors and senior management of the bank are ultimately responsible for operating it in a safe and sound manner.

In addition, many bank functions (investment management, asset/liability management, human resources, operations, internal audit, and loan review) may be performed on behalf of the bank by its parent bank holding company or by a nonbank affiliate. These functions are reviewed at inspections of the bank holding company. Examiners at the bank should be aware of the evaluation of these functions by inspection personnel, either at a concurrent inspection or in the report of a prior inspection. In addition, a review of these same issues at the level of the subsidiary bank is useful to determine compliance with corporate policies, corroborate inspection findings, and identify any inappropriate transactions that may have been overlooked in the more general, top-down review at the parent level.

INTERCOMPANY TRANSACTIONS

As with the supervision of subsidiaries, these issues should be reviewed at both the parent level during inspections and at the subsidiary-bank level during examinations to ensure that the transactions comply with sections 23A and 23B and do not otherwise adversely affect the financial condition of the bank.

Intercompany Tax Payments

As set forth in the ''Policy Statement Regarding Intercorporate Income Tax Accounting Transactions of Bank Holding Companies and State-Chartered Banks That Are Members of the Federal Reserve System'' (September 20, 1978), Federal Reserve policy relative to intercompany tax payments is to treat the bank as a separate taxpayer whose tax payments to its parent should not exceed payments it would make on a separate-entity basis. Payments should not be made to the parent before the time payments are or would have been made to the Internal Revenue Service. Refunds to the bank should be timely. Individual situations may result in complicated issues, and the examiner should consult with Reserve Bank personnel before conclusions are reached concerning a particular transaction. Bank holding company inspection report comments and bank examination report comments should be consistent concerning the nature and propriety of intercompany transactions.

Management and Other Fees

Banks often obtain goods and services from the parent bank holding company or an affiliated nonbank subsidiary. These arrangements may benefit the bank, since the supplier may offer lower costs because of economies of scale, such as volume dealing. Furthermore, banks may be able to purchase a package of services that otherwise might not be available. However, because of the interrelationship between the bank and the supplier, examiners should ensure that the fees being paid represent reasonable reimbursement for goods and services received. Fees paid by the bank to the parent or nonbank affiliates should have a direct relationship to, and be based solely on, the fair value of goods and services provided and a reasonable profit. Fees should compensate the affiliated supplier only for providing goods and services that meet the legitimate needs of the bank.

Banks should retain satisfactory records that substantiate the value of goods and services received, their benefit to the bank, and their cost-efficiencies. There are no other minimum requirements for records, but an examiner should be able to review the records maintained and determine that fees represent reasonable payment. In general, the supplier will decide on the amount to be charged by using one of three methods:

- reimbursement for cost of goods or services
- cost plus a reasonable profit margin
- comparative fair market value

Any of those methods may be acceptable as long as the bank can substantiate that the fees paid are reasonable for the value received. Basing fees on costs may be the most common approach since market comparisons often are difficult to obtain. A holding company may be able to offer a number of services on a cost basis to a subsidiary bank, any one of which might be contracted elsewhere for less; however, in the aggregate, they may be cost-effective or produce economies of scale for the entire organization. Nevertheless, having one or more subsidiary banks pay excessive fees for services to subsidize other unprofitable operations is not an acceptable practice.

When the servicer incurs overhead expenses, recovery of those costs is acceptable to the extent they represent a legitimate and integral part of the service rendered. Overhead includes salaries and wages, occupancy expenses, utilities, payroll taxes, supplies, and advertising. Debt-service requirements of holding companies, shareholders, or other related organizations are not legitimate overhead expenses for a subsidiary bank.

Generally, the payment of excessive fees is considered an unsafe and unsound practice. When fees are not justified, appear excessive, do not serve legitimate needs, or are otherwise abusive, the examiner should inform the board of directors through appropriate criticism in the report of examination.

Dividends

Dividends represent a highly visible cash outflow by banks. Should the dividend-payout ratio exceed the level at which the growth of retained earnings can keep pace with the growth of assets, the bank's capital ratios will deteriorate. Examiners should evaluate the appropriateness of dividends relative to the bank's financial condition, prospects, and asset-growth forecast.

Purchases or Swaps of Assets

Asset purchases or swaps between affiliates create the potential for abuse. Regulatory concern focuses on the fairness of such asset transactions, their financial impact, and timing. Fairness and financial considerations include the quality and collectibility of such assets and liquidity effects. Asset exchanges may represent a mechanism to avoid regulations designed to protect subsidiary banks from becoming overburdened with nonearning assets.

Compensating Balances

A subsidiary bank may be required to maintain excess balances at a correspondent bank that lends to other parts of the holding company organization, possibly to the detriment of the bank. The subsidiary bank may be foregoing earnings on such excess funds, which may adversely affect its financial condition.

Split-Dollar Life Insurance

Split-dollar life insurance is a type of life insurance in which the purchaser of the policy pays at least part of the insurance premiums and is entitled to only a portion of the cash surrender value, or death benefit, or both. In some circumstances, when the subsidiary bank pays all or substantially all of the insurance premiums, an unsecured extension of credit from the bank to its parent holding company generally results because the bank has paid the holding company's portion of the premium, and the bank will not be fully reimbursed until later. In other arrangements, when the parent uses the insurance policy as collateral for loans from the subsidiary bank, the loan may not meet the collateral requirements of section 23A. In addition, split-dollar arrangements may not comply with section 23B if the return to the bank is not commensurate with the size and nature of its financial commitment. Finally, split-dollar arrangements may be considered unsafe and unsound, which could be the case if the bank is paying the entire premium but is not the beneficiary, or if it receives less than the entire proceeds of the policy. Refer to SR-93-37 (“Split-Dollar Life Insurance,” June 18, 1993).

Other Transactions with Affiliates

Checking accounts of the parent or nonbank subsidiaries at subsidiary banks present the potential for overdrafts, which are regarded as unsecured extensions of credit to an affiliate by the subsidiary bank.

In general, a subsidiary bank should be adequately compensated for its services or for the use of its facilities and personnel by other parts of the holding company organization. In addition, a subsidiary bank should not pay for expenses for which it does not receive a benefit (for example, the formation expenses of a one-bank holding company).

Situations sometimes arise in which more than one legal entity in a banking organization shares offices and/or staff. In certain cases it can be hard to determine whether a legal entity is operating within the scope of its permissible activities. In addition, a counterparty may be unclear as to which legal entity an employee is representing. Finally, there may be expense-allocation problems and, thus, issues pertaining to sections 23A and 23B. Examiners should be aware of these concerns and make sure that institutions have the proper records and internal controls to ensure an adequate separation of legal entities. Refer to SR-95-34 (“Sharing of Facilities and Staff by Banking Organizations,” May 30 , 1995).

1. To determine if policies, procedures, and internal controls for bank-related organizations are adequate.
2. To determine if bank and affiliate management is complying with the established policies.
3. To determine compliance with applicable laws and regulations.
4. To evaluate the bank's investment in and loans to its related organizations and the propriety of those carrying values.
5. To determine the relationships between the bank and its related organizations and the effects of those relationships on the operations and safety and soundness of the bank.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

During the pre-examination analysis of the bank, a determination of which related organizations are to be examined in depth should be made. The criteria for that determination are:

- All operating subsidiaries should be examined concurrently with the regular examination of the parent bank, unless such examination is specifically waived by the Federal Reserve Bank.
- Other subsidiaries are examined except when relationships between the subsidiary, its parent and other related organizations are fully disclosed by material on hand, and the subsidiary's condition or operations are determined not to be detrimental to the safety and soundness of the bank. Factors to be considered in making the determination to examine a subsidiary are:
  - — The bank's percent of ownership and dollar amount of investment in the subsidiary.
  - — Nature of the subsidiary's business.
  - — Types and amounts of intercompany transactions.
  - — Types and amounts of participations and purchased, sold, or swapped assets between the subsidiary and the bank or other related organizations.
  - — Types of services performed by the subsidiary for the bank or other related organizations.
  - — Outstanding contingent liabilities by the bank in favor of the subsidiary.
  - — The bank's potential contingent liabilities, moral or legal, as a result of litigation, claims or assessments pending against the subsidiary.
  - — If practical under the circumstances, the parent holding company and nonbank affiliates should be inspected in conjunction with the examination of the lead state member bank. The decision to coordinate the timing of the bank holding company inspection and the state member bank examination should be based on the nature and extent of interaction between the bank and its parent holding company and nonbank affiliates. Factors to be considered in making the decision to coordinate the examination and inspection are:
    - — Dollar amount of loans or advances by the bank.
    - — Nature of business of the nonbank affiliates.
    - — Types and amount of intercompany transactions.
    - — Types and amounts of participations and other assets purchased, sold, or swapped.
    - — Types of services performed for or by and fees paid or received.
    - — Outstanding contingent liabilities by the bank in favor of its parent or nonbank affiliates.

    Factors which should be considered in making the determination to examine nonbanking subsidiaries within the parent holding company under inspection are detailed in the *Bank Holding Company Supervision Manual*.

The following procedural steps should be performed in all banks which have related organizations:

1. If selected for implementation, complete or update the Bank-Related Organizations section of the Internal Control Questionnaire.
2. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures.
3. Obtain the following reports and/or forms which, where appropriate, were prepared or filed since the preceding examination:
   a. Annual report on SEC Form 10–K or Federal Reserve Form F–2.
   b. Current report on SEC Form 8–K or Federal Reserve Form F–3.
   c. Quarterly report on SEC Form 10–Q or Federal Reserve Form F–4.
   d. Quarterly report on Federal Reserve Form Y–8.
   e. Annual report on Federal Reserve Form Y–6.
   f. Annual Report to Shareholders.
   g. Required reports under Federal Reserve Regulation K and to foreign banking authorities for foreign subsidiaries.
   h. Subsidiary and affiliate reports prepared by examiners.
   i. Federal reports of examination for nonbanking subsidiaries.

4. Request that the bank provide a list of the names of all related organizations setting forth the loans to and investments in these organizations and any management official interlocks among those organizations and the banks.
5. Circulate a list to examiners assigned to each bank department setting forth the names of the related organizations and the loans to, and investments in, these organizations. The accuracy and completeness of this information should be verified by the recipients.
6. Obtain information concerning receivables from, or payables to, related organizations from examiners assigned to ''Other Assets and Other Liabilities.''
7. Review the bank's files and reports obtained in step 3 and transcribe for the workpapers pertinent financial data and comments regarding related organizations.
8. Review fees paid by the bank to related organizations, bank insider-related organizations and stockholders and determine that they represent reasonable reimbursement for goods and services received by:
   a. Determining the method used to compute the charge to the bank for goods or services (cost, cost plus profit, fair market value).
   b. Reviewing documentation maintained by the bank substantiating the fair value of the goods or services received, their benefit to the bank, and the cost efficiencies of the alternative selected.
   c. Comparing schedule of fees currently in effect to those in effect 12 months ago.
   d. Comparing the fees paid during the last 3 months to those paid for the same period one year ago.
9. Based on the information obtained above, review the following for each related organization:
   a. The quality of loans, investments and future commitments to any related organization.
   b. The nature and volume of transactions between the related organization and the bank and:
      - Extent of any participations, and purchase, sale or swap of assets between the bank and the related organizations and the propriety of the transactions and related considerations.
      - Fees such organizations charge the bank for services rendered and the reasonableness of those fees.
      - Cash transfers to or from a related organization in connection with a consolidated income tax obligation. (Amounts paid should be based on that amount due if a separate return was filed. They should be paid only at such time to reasonably permit required estimated payments or final settlements to be made to the IRS.)
      - Fees received by the bank from such organization for use of bank personnel, premises, marketing services and equipment, etc., and the adequacy of those fees.
      - Any agreements, guarantees, pledges or hypothecations between the bank and any related organization and if they are properly reflected on the books of the bank, and whether there are any apparent conflict of interest situations.
   c. Litigation, where the related organization is a defendant in a suit, and if the litigation could have an adverse effect on the bank (from SEC Form 10–K or other source).
   d. Each interlocking officer and/or director relationship as reflected by the information obtained in step 4 and:
      - Whether fees or salaries are excessive for duties performed.
      - If adequate time is devoted to management responsibilities.
10. By coordinating work with the examiners assigned to the various loan areas, determine compliance with laws and regulations pertaining to related organizations by performing the following for:
    a. *Section 23A, Federal Reserve Act (12 USC 371(c))—Transactions with Affiliates:*
       - Obtain a listing of loans to affiliates.
       - Compare the listing to the bank's customer liability records to determine its accuracy and completeness.
       - Obtain a listing of other covered transactions with affiliates (i.e. purchase of securities issued by an affiliate, purchase of assets, acceptance of securities issued by an affiliate as collateral for a loan to any person or company, or the issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate).

- Ensure that transactions with affiliates do not exceed limits imposed by section 23A.
- Ensure that transactions with affiliates meet the collateral requirements of section 23A.
- Ensure that low quality loans have not been purchased from an affiliate.
- Determine that all transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.

b. *Section 23B, Federal Reserve Act (12 USC 371c-1)*—Restrictions on Transactions with Affiliates:

- Determine that covered transactions with affiliates comply with the restrictions contained in section 23B of the act.

c. *Regulation O (12 CFR 215)—Loans to Executive Officers, Directors, Principal Shareholders, and Their Interests:*

- Obtain lists of loans to executive officers and business interests of directors, executive officers, and principal shareholders from the examiner assigned ''Duties and Responsibilities of Directors.''
- Determine accuracy and completeness of the list as it concerns related organizations by comparing it to information obtained from management and other examiners.
- Investigate to determine undisclosed affiliate relationships if there are several directors or officers who have a common interest in the same entity by:
  — Obtaining a listing of all directors for the entity which is suspected of maintaining an affiliate relationship.
  — Reviewing authorizing signatures on corporate resolutions to borrow.
  — Reviewing signatory authorities on deposit signature cards.

11. If the bank operated an impermissible nonbank activity, determine that it has divested itself of that activity.
12. If the bank is a subsidiary of a holding company and the parent has sold commercial paper and funded bank loans with the proceeds, obtain or prepare the following schedules and forward them to the examiner assigned ''Funds Management:''
    a. Amount and maturities of commercial paper outstanding.
    b. Amount and maturity of assets that paper supports.
13. If the bank is a subsidiary of a holding company and the parent has sold long-term debt and passed the proceeds down to the bank in the form of equity, obtain or prepare the following schedules and forward them to the examiner assigned ''Assessment of Capital Adequacy:''
    a. Amount, maturity, and repayment terms of long-term debt sold.
    b. Amount of equity capital passed to bank.
    c. Expected minimum dividend payment required by bank to service debt of parent.
14. Determine, from the results of previous steps and discussion with management, if there are any anticipated changes in related organization/bank relationship which may possibly have adverse effects upon the affairs and soundness of the bank.
15. Based on the above steps, determine the propriety of the carrying value and nature of the relationship between the bank and its related organizations and the effect of that relationship upon the affairs and soundness of the bank.
16. If, in the performance of the above procedures, the full nature and extent of interaction between the bank and its related organizations cannot be determined, consider the necessity of an in-depth examination of related organizations. Perform appropriate procedures in step 17 and develop additional specific procedures based on type and scope of activities being conducted.
17. The following procedures should be considered where an in-depth examination of a bank's nonbank subsidiaries is deemed appropriate:
    a. Review and analyze the liability structure of the nonbank subsidiaries.
       - Review and appraise any funding agreements with parent bank.
       - Review and appraise any funding agreements with, and debt instruments issued to, outside creditors.
       - Review agreements with third parties involving outright purchase of assets to determine liability for repurchase of assets or any other contingent liabilities.

b. Analyze cash flow, earnings, and tax policies of the nonbank subsidiaries. Prepare cash flow statements for previous three fiscal years and compare current year-to-date with previous year-to-date.
c. Review and evaluate capital adequacy by:
   - Relating the consolidated classified assets of the subsidiaries against the consolidated net worth or relate classifieds proportionately to the parent's investment in and advances to each subsidiary.
   - Commenting on overall capital structure of both parent bank and specific nonbank subsidiaries, as warranted.
   - Discussing adequacy of capital with management and noting management's future plans to raise capital.
d. Review and evaluate management and control policies by:
   - Reviewing parent corporation board meeting minutes and assessing director interest in and awareness of subsidiaries.
   - Reviewing and evaluating corporate management's internal audit procedures for those policies.
   - Reviewing ''management letters'' from certified public accountants about those internal controls.
   - Reviewing shareholder records, noting significant concentrations and, in cases where officers/directors are involved, noting any undue influence with regard to policies, practices and procedures.
e. Review management's future operating plan for the subsidiary company and:
   - Analyze subsidiary's earnings and capital projections for one and five years.
     — Obtain underlying assumptions for:
     — Return on assets
     — Dividend retention rate
     — Asset growth rate
     — Capital growth rate
   - Compare projections against past operating performance and comment on plan.

18. Discuss findings and conclusions reached in the examination of any nonbank subsidiary with management of that entity. Prepare comments for the examination report.
19. Prepare, in appropriate report form, and discuss with appropriate bank management:
    a. The adequacy of written policies on related organizations.
    b. The manner in which bank officers are operating in conformance with established policy.
    c. Violations of laws or regulations.
    d. Impropriety of any transaction between the related organization and the bank.
    e. Loans to and/or investments in related organizations, which for any reason, the examiner questions quality, carrying value or ultimate collection.
    f. Litigation, commitments, contingent liabilities, and/or current or anticipated changes between the bank and its related organizations which may have adverse effects on the affairs and soundness of the bank.
    g. Interlocking officer and/or director relationships which are detrimental to the bank under examination or any of its related organizations.
    h. Any other information which will communicate the condition of the related organization and the nature and effect of the relationship between the related organization and the bank under examination.
    i. Recommended corrective action when policies, practices or procedures are deficient.
20. Consolidate information contained in the operating subsidiary report(s) for inclusion in the report of examination.
21. Consolidate financial information and any other comments concerning related organizations for inclusion, where appropriate, in the report of examination.
22. If material changes have occurred in related organizations since the most recent examination of the bank which may have a substantial impact on the bank, such information should be communicated by separate memorandum to the Federal Reserve Bank.
23. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures concerning related organizations. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information.

POLICIES AND OBJECTIVES

1. Does the bank have written guidelines with regard to expansion of services through the formation and/or acquisition of related organizations?
2. To determine that established objectives and policies are adhered to:
   a. Is there an overall lending policy that would bring banking and nonbanking related organizations under a common set of controls?
   b. Are bank officials an integral part of subsidiary or related company management?
   c. Can operating procedures be monitored from available internal or external audit reports?
3. Are periodic independent reviews performed to assess bank management objectives and policies with regard to the current status of their association with the related organizations?
4. Does bank management have an active role in the related organizations' audit committees or do they retain the right to examine the companies records including the right to receive third party letters from the external auditors?
5. Are policies and procedures such that the effect upon the bank's liquidity is monitored when commercial paper or other proceeds are used to fund bank loans?

RECORDS

6. Are records maintained for the companies in which the bank has a capital investment including foreign ones, so that a determination can be made of the extent of bank control, quality of assets, profitability of the company, and legality of operations?
7. Does the bank maintain current records on the form and status of each related organization (such a list should include name, location, nature of business, manner of affiliation, relationship with bank, amount of loans, investments in, and other extensions of credit, security pledged, obligations of any affiliate which is used as collateral security for advances made to others, commitments and litigation)?
8. Does the bank maintain a copy of all internal and/or external audit reports, including management letters and responses, of the subsidiary or related company?
9. In the case of registered bank holding companies and nonbank affiliates arising through the holding company relationship, are copies of the Federal Reserve's inspection reports and forms 10–Q, 10–K, 8–K, Y–6, and Y–8 available for review?
10. In the case of Edge Act and agreement corporations and foreign subsidiaries are copies of Federal Reserve examination reports and foreign regulatory reports available for review?
11. Do credit files of foreign subsidiaries include information regarding a particular country's cultural and legal influences upon banking activities, current economic conditions, anticipated relaxation or strengthening of capital or exchange controls, fiscal policy, political goals, and risk of expropriation?
12. Is the carrying value of all subsidiaries and related companies accounted for on the equity basis and adjusted, at least quarterly, to reflect the reporting bank's cumulative share of the company's earnings or losses?
13. Is an objective review performed of the benefits or quality of assets received relative to the cost incurred?
14. Are money transfers between bank and any related organization adequately documented to justify the equity of the transaction?

CONCLUSION

15. Is the foregoing information considered an adequate basis for evaluating internal con-

trols in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

16. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/ inadequate).